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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1982

ORIGINAL

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

COMPLETED

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

OVERSIGHT ON THE MIDYEAR MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 20, 21, AND 27, 1982

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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CONTENTS

TUESDAY, JULY 20, 1982

Page

Opening statement of Chairman Garn 1
Opening statements of:
- Senator Riegle 2
- Senator Tower 33
- Senator Sasser 34
- Senator Schmitt 34

WITNESS

Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System 4
- Monetary and credit targets 6
- Blend of monetary and fiscal policy 10
- Concluding comments 11
- Midyear monetary policy report to Congress 14
- Answers to subsequent written questions of Senator Schmitt 79

Panel discussion:
- Congress blamed 35
- Failure to meet target growth 36
- Need for major change in policy mix 38
- Flight of money to short-term securities 41
- Effect of unregulated money market funds 42
- Turned the corner on inflation 44
- Ideas to change budget process 46
- Poor economy causes large lasting deficits 48
- Economic recovery predicted 49
- Constitutional amendment 50
- Impact of Government borrowing 53
- Huge short-term borrowing 53
- Administration supportive of present monetary policy 55
- Possibilities of lower interest rates 57
- Monetary policy counterproductive 58
- Amendment for national economic emergencies 60
- Small business bankruptcies 63
- Interest rates continue to rise 64
- Pressure on monetary policy 65
- Same debates and arguments 67
- Administration to stand pat on economic policy 70
- Fed response to sinking economy 72
- Record borrowing by the Treasury 74
- Cutting taxes 77
- Rash of farm foreclosures 78
- Investors sitting on short-term money 78

WEDNESDAY, JULY 21, 1982

WITNESSES

Murray L. Weidenbaum, Chairman, Council of Economic Advisers 83
- Prepared statement 85
  - Selecting a definition of money 85

Murray L. Weidenbaum, Chairman, Council of Economic Advisers—Continued
Prepared statement—Continued

Page
Setting and achieving monetary growth targets 89
Variability of money growth 94
Improved monetary control 98
Conclusion 99
Table 1—Composition of M_1 87
Figure 1—Income velocity of money 92

Panel discussion:

Budget predictions constantly underestimated 100
Serious economic conditions 102
Difficult times are behind us 104
Time is running out 104
Recession bottomed out 106
Trillion dollar debt 107
Reduction of money supply 110
Grant item veto power to the President 112
Targeting interest rates 113
Housing bill vetoed 125
Bailout approach 116
Characterizing Fed's monetary policy 118
Discount rate lowered 119
Foreign economic growth 122
Frustration of politics 126
Letter to Senator Sarbanes regarding the growth of money and its velocity in Germany and Japan compared to the United States 123
Midcourse correction in economic policy 128
Donald E. Maude, Chief Financial Economist and Chairman, Interest Rate Policy Committee, Financial Economic Research Department, Merrill Lynch, Pierce, Fenner & Smith, New York, N.Y 132
Prepared statement 133
The setting 134
Possible reconciliation 135
Monthly changes in M_{1B} 138
M_2 Growth 140
Monetary policy conduct considerations 141
Remarks 143
Weekly credit market bulletins 152
Credit Market Digest 158
Serious contradictions 165
M_2 growing above targets 167
Eliminate "base drift" 168
Leif H. Olsen, Chairman, Economic Policy Committee, Citibank, N.A., New York, N.Y 169
Prepared statement 170

Panel discussion:

Contemporaneous reserve adjustment 176
Federal deficits 177
Balancing the budget 179
Social security problem 181

TUESDAY, JULY 27, 1982

WITNESSES

Beryl W. Sprinkel, Under Secretary of the Treasury for Monetary Affairs 183
Views and recommendations 184
Gradual deceleration of money growth 185
Summary of study titled "The Effect of Volatile Money Growth on Interest Rates and Economic Activity" 189
Curb excessive Government spending 200
Prepared statement 202
Summary 212
Chart I—Growth in nominal GNP and adjusted monetary growth 214
Chart II—Growth in M_1 and the monetary base 215
Chart III—Short-term monetary growth and short-term interest rates 216

Beryl W. Sprinkel, Under Secretary of the Treasury for Monetary Affairs—Continued

Page
- Predicting monetary growth 217
- Federal Reserve targets 219
- Continuous deficit 219
- Good prospects for a recovery 222
- Subsequent additional statement on alternative ways to reduce interest rates 224

Steven M. Roberts, Director, Government Affairs, American Express Co 225
- Monetary and fiscal policies 225
- Recommendations 226
- Prepared statement 227
  - Newspaper article from the Washington Post entitled, "Companies Rushing to Borrow Funds" 247
  - Testimony of Benjamin M. Friedman, professor of economics, Harvard University, before the House Committee on Banking, Finance and Urban Affairs 248
  - Proposal for fiscal responsibility and lower interest rates 262
  - Proposed joint resolution to reduce total Federal outlays as a share of GNP 269
  - Analysis of the proposed joint resolution 270
- Controlling total net credit 271
- Comparing M_1 after 5 years 272
- Adjusting prime rates to cost of funds 273
- Problem controlling target for M_1 275
- Answers to subsequent written questions of Senator Riegle 278
- Reprint of paper by Alan Reynolds titled "The Trouble With Monetarism" 282

ADDITIONAL MATERIAL RECEIVED FOR THE RECORD

Statement by Jack Carlson, vice president and chief economist, National Association of Realtors 306

FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1982

TUESDAY, JULY 20, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m. in room 5302 of the Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Tower, Lugar, Chafee, Schmitt, Brady, Riegle, Proxmire, Cranston, Sarbanes, Dixon, and Sasser.

The CHAIRMAN. The Banking Committee will come to order.

Chairman Volcker, we are happy to have you with us this morning, to hear your report on monetary policy. I hope that we will be able to have a discussion with members of the Banking Committee that avoids a lot of rhetoric, as we discuss the current condition of the U.S. economy, together with the appropriateness of recent prospective monetary policies.

To have a constructive discussion, we must not ignore the very real economic challenges that we face. Constructive discussion, however, will also require that we not ignore the equally real progress that has been made since we began our efforts to slow inflation and curtail the government's growth rate—less than 19 months ago.

Mr. Chairman, in the interest of time—we came to hear you today—and I would put the balance of my comments in the record, and turn to Senator Riegle for any comments that he might have before you begin, and then to Senator Dixon.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. I hope that we will be able to avoid rhetoric this morning as we discuss the current condition of the U.S. economy together with the appropriateness of recent and prospective monetary policy. To have a constructive discussion, we must not ignore the very real economic challenges we face. A constructive discussion, however, will also require that we will also require that we not ignore the equally real progress that has been made since we began our efforts to slow inflation and curtail government's growth rate less than 19 months ago.

Certainly, our greatest success has been in combatting what was acknowledged to be our country's No. 1 economic problem when Ronald Reagan was elected President. During the 6 months prior to his inauguration, consumer prices rose at a 10.3-percent annual rate. Over the last 6 months, consumer prices have risen at an annual rate of only 3.7 percent.

By holding firm to a commitment to gradually slow the monetary aggregates' growth rate, the Federal Reserve has played a central role in the successful fight against inflation.

With inflation down, our greatest current challenge is to hasten a decline in interest rates so that the job-creating potential of our economy can be released.

Today I applaud the Federal Reserve's commitment to removing money-growth volatility as a contributor to high rates, as evidenced by your decision to try to use contemporaneous reserve accounting to improve your short-term control over the aggregates.

Nevertheless, I remain convinced that it is the Congress that is primarily to blame for the failure of interest rates to decline as quickly as inflation. The first budget resolution which we recently passed calls for steadily declining Federal deficit in the years ahead: $104 billion in fiscal year 1983; $84 billion in fiscal year 1984; and $60 billion in fiscal year 1985.

But of the $281 billion in spending cuts that will be necessary over the next 3 years to achieve these declining deficits, only $27 billion—less than 10 percent—have been reconciled or enacted into law.

Is it any wonder that the financial markets have remained skeptical—as evidenced by the stickiness of interest rates—of Congress ability to make the budget cuts called for in the budget resolution?

Still, I began this statement with a call for a constructive discussion, one that acknowledges accomplishments as well as remaining problems. In this spirit, we must acknowledge that an important start has been made toward lowering interest rates.

In the 4 years before Ronald Reagan began charting a new economic future, rates rose steadily. From an average of only 4.4 percent in December 1976, the yield on 3-month Treasury bills rose to: 6.1 percent in December 1977; 9.1 percent in December 1978; 12.1 percent in December 1979; and 15.7 percent in December 1980.

Yesterday that rate had come back down to just over 11 percent. Similarly, while the prime rate has not declined nearly enough, it is down substantially from the 21.5 percent Ronald Reagan inherited.

From much of what you hear and read today, you might think rates were up—instead of down—from where they were 19 months ago.

In conclusion, I again call for a discussion that does not fail to confront problems head-on and also does not fail to give credit where credit is due.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Thank you, Mr. Chairman.

Mr. Volcker, it's good to have you back before the committee today.

As I have had the chance to talk with leading financial and economic people across the country, business people, labor people, and citizens at the grassroots level, it's clear from everything I am hearing that the economy is in very, very serious trouble.

If I were to try to assess the bottom line, of what I'm hearing from this cross-section of opinion in the country, it is that the country now, economically, seems to be on a disaster course, unless major changes are made, unless the Federal deficits come down, and come down substantially, unless the interest rates come down, and come down substantially and stay down for a period of time; that unless these things are done, we are going to find ourselves in a situation where unemployment will go higher, the rate of bankruptcies—which is running at 550 firms a week—would likely go higher.

We've got a number of interest rate-sensitive sectors of the economy in terrible difficulty. Certainly the savings and loan industry is in that situation. Agriculture and farming are increasingly in that situation. The auto industry is at less than 50 percent of capacity operation. The steel industry is running at about 40 percent of capacity. The construction and the real estate industries are devastated.

The headline today, on the front of the business section of the Washington Post, indicates that housing starts declined 15.3 percent from May—and we're now facing the worst year for housing in the United States since World War II.

Capital investment plans have dropped off.

If we consider all of this information, it shows that we are really in extremely serious trouble. The question is: How are we going to change this?

What is the Fed doing to change it?

What are you saying in your conversations with the President?

What is his response to you?

Are we going to be able to get these rates down?

Are they going to come down soon?

Will they come down enough to make a difference?

And if not, then what is our contingency plan?

If we stay on this course and the damage and the destruction and the hardship continue to accumulate, then the question is: How do we propose to treat those problems, which are mounting every day, in every place that we look?

We have over 10.5 million people out of work in the country; and that does not count another 1½ million that are no longer included in the statistics because they have lost their unemployment benefits.

So, the situation is really at a desperate point. I'm going to be very interested to hear both your assessment of the seriousness of the problem and how you feel that the Fed and the rest of us can change these policies and improve the picture as it now appears.

The CHAIRMAN. Senator Brady, do you have any comments you wish to make?

Senator BRADY. No comments, thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, I will make my statement after the witness has concluded.

The CHAIRMAN. Chairman Volcker, it is yours.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, I am pleased to have this opportunity once again to discuss monetary policy with you, within the context of recent and prospective economic developments.

As usual on these occasions, you have the Board of Governors' Humphrey-Hawkins report before you. This morning I want to enlarge upon some aspects of that report and amplify as fully as I can my thinking with respect to the period ahead.

In assessing the current economic situation, I believe the comments I made 5 months ago remain relevant. Without repeating that analysis in detail, I would emphasize that we stand at an important crossroads for the economy and economic policy.

In these past 2 years, we have traveled a considerable way toward reversing the inflationary trend of the previous decade or more.

I would recall to you that, by the late 1970's, that trend had shown every sign of feeding upon itself and tending to accelerate to the point where it threatened to undermine the foundations of our economy. Dealing with inflation was accepted as a top national priority, and, as events developed, that task fell almost entirely to monetary policy.

In the best of circumstances, changing entrenched patterns of inflationary behavior and expectations—in financial markets, in the practices of business and financial institutions, and in labor negotiations—is a difficult and potentially painful process. Those, consciously or not, who have come to bet on rising prices and the ready availability of relatively cheap credit to mask the risks of rising costs, poor productivity, aggressive lending, or overextended financial positions, have found themselves in a particularly difficult position.

The pressures on financial markets and interest rates have been aggravated by concerns over prospective huge volumes of Treasury financing, and by the need of some businesses to borrow at a time of a severe squeeze on profits. Lags in the adjustment of nominal wages and other costs to the prospects for sharply reduced inflation are perhaps inevitable, but have the effect of prolonging the pressure on profits—and indirectly on financial markets and employment.

Remaining doubts and skepticism that public policy will carry through on the effort to restore stability also affect interest rates, perhaps most particularly in the longer term markets.

In fact, the evidence now seems to me strong that the inflationary tide has turned in a fundamental way. In stating that, I do not rely entirely on the exceptionally favorable consumer and producer price data thus far this year, when the recorded rates of price increase, at annual rates, declined to 3½ and 2½ percent, respectively. That apparent improvement was magnified by some factors likely to prove temporary, including, of course, the intensity of the recession; those price indexes are likely to appear somewhat less favorable in the second half of the year.

What seems to me more important for the longer run is that the trend of underlying costs and nominal wages has begun to move lower, and that trend should be sustainable as the economy recovers upward momentum. While less easy to identify—labor productivity typically does poorly during periods of business decline—there are encouraging signs that both management and workers are giving more intense attention to the effort to improve productivity. That effort should pay off in a period of business expansion, helping to hold down costs and encouraging a revival of profits, setting the stage for the sustained growth in real income we want.

I am acutely aware that these gains against inflation have been achieved in a context of serious recession. Millions of workers are unemployed, many businesses are hard pressed to maintain profitability, and business bankruptcies are at a postwar high.

While it is true that some of the hardship can reasonably be traced to mistakes in management or personal judgment, including presumptions that inflation would continue, large areas of the country and sectors of the economy have been swept up in more generalized difficulty. Our financial system has great strength and resiliency, but particular points of strain have been evident.

Quite obviously, a successful program to deal with inflation, with productivity, and with the other economic and social problems we face cannot be built on a crumbling foundation of continuing recession. As you know, there have been some indications—most broadly reflected in the rough stability of the real GNP in the second quarter and small increases in the leading indicators—that the downward adjustments may be drawing to a close. The tax reduction effective July 1, higher social security payments, rising defense spending and orders, and the reductions in inventory already achieved, all tend to support the generally held view among economists that some recovery is likely in the second half of the year.

I am also conscious of the fact that the leveling off of the GNP has masked continuing weakness in important sectors of the economy. In its early stages, the prospective recovery must be led largely by consumer spending. But to be sustained over time, and to support continuing growth in productivity and living standards, more investment will be necessary.

At present, as you know, business investment is moving lower. House building has remained at depressed levels; despite some small gains in starts during the spring, the cyclical strength normal in that industry in the early stages of recovery is lacking. Exports have been adversely affected by the relative strength of the dollar in exchange markets.

I must also emphasize that the current problems of the American economy have strong parallels abroad. Governments around the world have faced, in greater or lesser degree, both inflationary and fiscal problems. As they have come to grips with those problems, growth has been slow or nonexistent, and the recessionary tendencies in various countries have fed back, one on another.

In sum, we are in a situation that obviously warrants concern, but also has great opportunities. Those opportunities lie in major part in achieving lasting progress—in pinning down and extending what has already been achieved—toward price stability. In doing so, we will be laying the base for sustaining recovery over many years ahead, and for much lower interest rates, even as the economy grows.

Conversely, to fail in that task now, when so much headway has been made, could only greatly complicate the problems of the economy over time. I find it difficult to suggest when and how a credible attack could be renewed on inflation should we neglect completing the job now. Certainly the doubts and skepticism about our capacity to deal with inflation—which now seems to be yielding—would be amplified, with unfortunate consequences for financial markets and ultimately for the economy.

I am certain that many of the questions, concerns, and dangers in your mind lie in the short run—and that those in good part revolve around the pressures in financial markets. Can we look forward to lower interest rates to support the expansion in investment and housing as the recovery takes hold? Is there, in fact, enough liquidity in the economy to support expansion—but not so much that inflation is reignited? Will, in fact, the economy follow the recovery path so widely forecast in coming months?

These are the questions that we in the Federal Reserve must deal with in setting monetary policy. As we approach these policy decisions, we are particularly conscious of the fact that monetary policy, however important, is only one instrument of economic policy. Success in reaching our common objective of a strong and prosperous economy depends upon more than appropriate monetary policies, and I will touch this morning on what seems to me appropriately complementary policies in the public and private sectors.

THE MONETARY TARGETS

Five months ago, in presenting our monetary and credit targets for 1982, I noted some unusual factors could be at work tending to increase the desire of individuals and businesses to hold assets in the relatively liquid forms encompassed in the various definitions of money. Partly for that reason—and recognizing that the conventional base for the M_1 target of the fourth quarter of 1981 was relatively low—I indicated that the Federal Open Market Committee contemplated growth toward the upper ends of the specified ranges. Given the bulge early in the year in M_1, the committee also contemplated that that particular measure of money might for some months remain above a straight line projection of the targeted range from the fourth quarter of 1981 to the fourth quarter of 1982.

As events developed, M_1 and M_2 both remained somewhat above straight line paths until very recently. M_3 and bank credit have remained generally within the indicated range, although close to the upper ends. See table I. Taking the latest full month of June, M_1 grew 5.6 percent from the base period and M_2 9.4 percent, close to the top of the ranges. To the second quarter as a whole, the growth was higher, at 6.8 and 9.7 percent, respectively. Looked at on a year-over-year basis, which appropriately tends to average through volatile monthly and quarterly figures, M_1 during the first half of 1982 averaged about 4¾ percent above the first half of 1981, after accounting for NOW account shifts early last year. On the same basis, M_2 and M_3 grew by 9.7 and 10.5 percent, respectively, a rate

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of growth distinctly faster than the nominal GNP over the same interval.

In conducting policy during this period, the committee was sensitive to indications that the desire of individuals and others for liquidity was unusually high, apparently reflecting concerns and uncertainties about the business and financial situation. One reflection of that may be found in unusually large declines in velocity over the period—that is, the ratio of measures of money to the gross national product. M_1 velocity—particularly for periods as short as 3 to 6 months—is historically volatile. A cyclical tendency to slow, relative to its upward trend, during recessions is common. But an actual decline for two consecutive quarters, as happened late in 1981 and the first quarter of 1982, is rather unusual. The magnitude of the decline during the first quarter was larger than in any quarter of the entire postwar period. Moreover, declines in velocity of this magnitude and duration are often accompanied by, and are related to, reduced short-term interest rates. Those interest rate levels during the first half of 1982 were distinctly lower than during much of 1980 and 1981, but they rose above the levels reached in the closing months of last year.

More direct evidence of the desire for liquidity or precautionary balances affecting M_1 can be found in the behavior of NOW accounts. As you know, NOW accounts are a relatively new instrument, and we have no experience of behavior over the course of a full business cycle. We do know that NOW accounts are essentially confined to individuals, their turnover relative to demand accounts is relatively low, and, from the standpoint of the owner, they have some of the characteristics of savings deposits, including a similarly low interest rate but easy access on demand. We also know the great bulk of the increase in M_1 during the early part of the year—almost 90 percent of the rise from the fourth quarter of 1981 to the second quarter of 1982—was concentrated in NOW accounts, even though only about one-fifth of total M_1 is held in that form. In contrast to the steep downward trend in low-interest savings accounts in recent years, savings account holdings have stabilized or even increased in 1982, suggesting the importance of a high degree of liquidity to many individuals in allocating their funds. A similar tendency to hold more savings deposits has been observed in earlier recessions.

I would add that the financial and liquidity positions of the household sector of the economy, as measured by conventional liquid asset and debt ratios, has improved during the recession period. Relative to income, debt repayment burdens have declined to the lowest level since 1976. Trends among business firms are clearly mixed. While many individual firms are under strong pressure, some rise in liquid asset holdings for the corporate sector as a whole appears to be developing. The gap between internal cash flow—that is, retained earnings and depreciation allowances—and spending for plant, equipment, and inventory has also been at a historically low level, suggesting that a portion of recent business credit demands is designed to bolster liquidity. But, for many years business liquidity ratios have tended to decline, and balance sheet ratios have reflected more dependence on short-term debt. In that perspective, any recent gains in liquidity appear small.

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In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transaction purposes during the months of recession, strong efforts to reduce further the growth rate of the monetary aggregates appeared inappropriate. Such an effort would have required more pressure on bank reserve positions—and presumably more pressures on the money markets and interest rates in the short run. At the same time, an unrestrained buildup of money and liquidity clearly would have been inconsistent with the effort to sustain progress against inflation, both because liquidity demands could shift quickly and because our policy intentions could easily have been misconstrued. Periods of velocity decline over a quarter or two are typically followed by periods of relatively rapid increase. Those increases tend to be particularly large during cyclical recoveries. Indeed, velocity appears to have risen slightly during the second quarter, and the growth in NOW accounts has slowed.

Judgments on these seemingly technical considerations inevitably take on considerable importance in the target-setting process because the economic and financial consequences—including the consequences for interest rates—of a particular M_1 or M_2 increase are dependent on the demand for money. Over longer periods, a certain stability in velocity trends can be observed, but there is a noticeable cyclical pattern. Taking account of those normal historical relationships, the various targets established at the beginning of the year were calculated to be consistent with economic recovery in a context of declining inflation. That remains our judgment today. Inflation has, in fact, receded more rapidly than anticipated at the start of the year potentially leaving more room for real growth. On that basis, the targets established early in the year still appeared broadly appropriate, and the Federal Open Market Committee decided at its recent meeting not to change them at this time.

However, the committee also felt, in the light of developments during the first half, that growth around the top of those ranges would be fully acceptable. Moreover—and I would emphasize this—growth somewhat above the targeted ranges would be tolerated for a time in circumstances in which it appeared that precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money.

We will look to a variety of factors in reaching that judgment, including such technical factors as the behavior of different components in the money supply, the growth of credit, the behavior of banking and financial markets, and, more broadly, the behavior of velocity and interest rates.

I believe it is timely for me to add that, in these circumstances, the Federal Reserve should not be expected to respond, and does not plan to respond, strongly to various bulges—or for that matter valleys—in monetary growth that seem likely to be temporary. As we have emphasized in the past, the data are subject to a good deal of statistical noise in any circumstances, and at times when demands for money and liquidity may be exceptionally volatile, more than usual caution is necessary in responding to blips.[1]

We, of course, have a concrete instance at hand of a relatively large—and widely anticipated—jump in M_1 in the first week of July—possibly influenced to some degree by larger social security payments just before a long weekend. Following as it did a succession of money supply declines, that increase brought the most recent level for M_1 barely above the June average, and it is not of concern to us.

It is in this context, and in view of recent declines in short-term market interest rates, that the Federal Reserve yesterday reduced the basic discount rate from 12 to 11½ percent.

In looking ahead to 1983, the Open Market Committee agreed that a decision at this time would—even more obviously than usual—need to be reviewed at the start of the year in light of all the evidence as to the behavior of velocity or money and liquidity demand during the current year. Apart from the cyclical influences now at work, the possibility will need to be evaluated of a more lasting change in the trend of velocity.

The persistent rise in velocity during the past 20 years has been accompanied by rising inflation and interest rates—both factors that encourage economization of cash balances. In addition, technological change in banking—spurred in considerable part by the availability of computers—has made it technically feasible to do more and more business on a proportionately smaller cash base. With incentives strong to minimize holdings of cash balances that bear no or low interest rates, and given the technical feasibility to do so, turnover of demand deposits has reached an annual rate of more than 300, quadruple the rate 10 years ago. Technological change is continuing, and changes in regulation and bank practices are likely to permit still more economization of M_1-type balances. However, lower rates of interest and inflation should moderate incentives to exploit that technology fully. In those conditions, velocity growth could slow, or conceivably at some point stop.

To conclude that the trend has, in fact, changed would clearly be premature, but it is a matter we will want to evaluate carefully as time passes. For now, the committee felt that the existing targets should be tentatively retained for next year. Since we expect to be around the top end of the ranges this year, those tentative targets would, of course, be fully consistent with somewhat slower growth in the monetary aggregates in 1983. Such a target would be appropriate on the assumption of a more or less normal, cyclical rise in velocity. With inflation declining, the tentative targets would appear consistent with, and should support, continuing recovery at a moderate pace.

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[1] In that connection, a number of observers have noted that the first month of a calendar quarter—most noticeably in January and April—sometimes shows an extraordinarily large increase in M_1—amplified by the common practice of multiplying the actual change by 12 to show an annual rate. Those bulges, more typically than not, are partially washed out by slower than normal growth the following month. The standard seasonal adjustment techniques we use to smooth out monthly money supply variations—indeed, any standard techniques—may, in fact, be incapable of keeping up with rapidly changing patterns of financial behavior, as they affect seasonal patterns. A note attached to this statement sets forth some work in process developing new seasonal adjustment techniques.

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BLEND OF MONETARY AND FISCAL POLICY

The Congress, in adopting a budget resolution contemplating cuts in expenditures and some new revenues, also called upon the Federal Reserve to "reevaluate its monetary targets in order to assure that they are fully complementary to a new and more restrained fiscal policy." I can report that members of the committee welcomed the determination of the Congress to achieve greater fiscal restraint, and I want particularly to recognize the leadership of members of the Budget Committees and others in achieving that result. In most difficult circumstances, progress is being made toward reducing the huge potential gap between receipts and expenditures. But I would be less than candid if I did not also report a strong sense that considerably more remains to be done to bring the deficit under control as the economy expands. The fiscal situation, as we appraise it, continues to carry the implicit threat of crowding out business investment and housing as the economy grows—a process that would involve interest rates substantially higher than would otherwise be the case. For the more immediate future, we recognized that the need remains to convert the intentions expressed in the budget resolution into concrete legislative action.

In commenting on the budget, I would distinguish sharply between the cyclical and structural deficit—that is, the portion of the deficit reflecting an imbalance between receipts and expenditures even in a satisfactorily growing economy with declining inflation. To the extent the deficit turns out to be larger than contemplated entirely because of a shortfall in economic growth, that add on would not be a source of so much concern. But the hard fact remains that, if the objectives of the budget resolution are fully reached, the deficit would be about as large in fiscal 1983 as this year, even as the economy expands at a rate of 4 to 5 percent a year and inflation—and thus inflation-generated revenues—remains higher than members of the Open Market Committee now expect.

In considering the question posed by the budget resolution, the Open Market Committee felt that full success in the budgetary effort should itself be a factor contributing to lower interest rates and reduced strains in financial markets. It would thus assist importantly in the common effort to reduce inflationary pressures in the context of a growing economy. By relieving concern about future financing volume and inflationary expectations, I believe, as a practial matter, a credibly firmer budget posture might permit a degree of greater flexibility in the actual short-term execution of monetary policy without arousing inflationary fears. Specifically, market anxiety that shortrun increases in the Ms might presage continuing monetization of the debt could be ameliorated. But any gains in these respects will, of course, be dependent on firmness in implementing the intentions set forth in the resolution and on encouraging confidence among borrowers and investors that the effort will be sustained and reinforced in coming years.

Taking account of all these considerations, the committee did not feel that the budgetary effort, important as it is, would in itself appropriately justify still greater growth in the monetary aggregates over time than I have anticipated. Indeed, excessive monetary growth—and perceptions thereof—would undercut any benefits from the budgetary effort with respect to inflationary expectations. We believe fiscal restraint should be viewed more as an important complement to appropriately disciplined monetary policy than as a substitute.

CONCLUDING COMMENTS

In an ideal world, less exclusive reliance on monetary policy to deal with inflation would no doubt have eased the strains and high interest rates that plague the economy and financial markets today. To the extent the fiscal process can now be brought more fully to bear on the problem, the better off we will be—the more assurance we will have that interest rates will decline and keep declining during the period of recovery, and that we will be able to support the increases in investment and housing essential to healthy, sustained recovery. Efforts in the private sector—to increase productivity, to reduce costs, and to avoid inflationary and job-threatening wage increases—are also vital, even though the connection between the actions of individual firms and workers and the performance of the economy may not always be self-evident to the decisionmakers. We know progress is being made in these areas, and more progress will hasten full and strong expansion.

But we also know that we do not live in an ideal world. There is strong resistance to changing patterns of behavior and expectations ingrained over years of inflation. The slower the progress on the budget, the more industry and labor build in cost increases in anticipationg of inflation or Government acts to protect markets or impede competition, the more highly speculative financing is undertaken, the greater the threat that available supplies of money and credit will be exhausted in financing rising prices instead of new jobs and growth. Those in vulnerable, competitive positions are most likely to feel the impact first and hardest, but unfortunately the difficulties spread over the economic landscape.

The hard fact remains that we cannot escape those dilemmas by a decision to give up the fight on inflation—by declaring the battle won before it is. Such an approach would be transparently clear—not just to you and me— but to the investors, the businessmen, and the workers, who would, once again, find their suspicions confirmed that they had better prepare to live with inflation and try to keep ahead of it. The reactions in financial markets and other sectors of the economy would, in the end, aggravate our problems, not eliminate them. It would strike me as the cruelest blow of all to the millions who have felt the pain of recession directly to suggest, in effect, it was all in vain.

I recognize months of recession and high interest rates have contributed to a sense of uncertainty. Businesses have postponed investment plans. Financial pressures have exposed lax practices and stretched balance-sheet positions in some institutions—financial as well as nonfinancial. The earnings position of the thrift industry remains poor.

But none of those problems can be dealt with successfully by reinflation or by a lack of individual discipline. It is precisely that environment that contributed so much to the current difficulties.

In contrast, we are now seeing new attitudes of cost containment and productivity growth—and ultimately our industry will be in a more robust competitive position. Millions are benefiting from less rapid price increases—or acutally lower prices—at their shopping centers and elsewhere. Consumer spending appears to be moving ahead and inventory reductions help set the stage for production increases.

Those are developments that should help recovery get firmly underway. The process of disinflation has enough momentum to be sustained during the early stages of recovery—and that success can breed further success as concerns about inflation recede. As recovery starts, the cash flow of business should improve. And, more confidence should encourage greater willingness among investors to purchase longer debt maturities. Those factors should, in turn, work toward reducing interest rates, and sustaining them at lower levels, encouraging in turn the revival of investment and housing we want.

I have indicated the Federal Reserve is sensitive to the special liquidity pressures that could develop during the current period of uncertainty.

Moreover, the basic solidity of our financial system is backstopped by a strong structure of governmental institutions precisely designed to cope with the secondary effects of isolated failures. The recent problems related largely to the speculative activities of a few highly leveraged firms can and will be contained. And over time, an appropriate sense of prudence in taking risks will serve us well.

We have been through—we are in—a trying period. But too much has been accomplished not to move ahead and complete the job of laying the groundwork for a much stronger economy. As we look forward, not just to the next few months but to long years, the rewards will be great: In renewed stability, in growth, and in higher employment and standards of living.

That vision will not be accomplished by monetary policy alone. But we mean to do our part.

[Additional material received from the Federal Reserve Board follows:]

TABLE I.—TARGETED AND ACTUAL GROWTH OF MONEY AND BANK CREDIT

[Percent changes, at seasonally adjusted annual rates]

	FOMC objective 1981Q4 to 1984Q4	Actual growth		
		1981Q4 to June 1982	1981Q4 to 1982Q2	1981H1 to 1982H1
M_1	2½ to 5½	5.6	6.8	[2] 4.7
M_2	6 to 9	9.4	9.7	9.7
M_3	6½ to 9½	9.7	9.8	10.5
Bank credit [1]	6 to 9	8.0	8.3	8.4

[1] The base for the bank credit target is the average level of December 1981 and January 1982, rather than the average for 1981Q4. This base was adopted because of the impact on the series of shifts of assets to the new international banking facilities [IBF's]; the 1981H1-to-1982H1 figure has been adjusted for the impact of the initial shifting of assets to IBF's.

[2] Adjusted for impact of shifts to new NOW accounts in 1981.

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APPENDIX—ALTERNATIVE SEASONAL ADJUSTMENT PROCEDURE

For some time the Federal Reserve has been investigating ways to improve its procedures for seasonal adjustment, particularly as they apply to the monetary aggregates. In June of last year, a group of prominent outside experts, asked by the Board to examine seasonal adjustment techniques, submitted their recommendations.[1] The committee suggested, among other things, that the Board's staff develop seasonal factor estimates from a model-based procedure as an alternative to the widely used X–11 technique that provides the basis for the current seasonal adjustment procedure,[2] and release the results.

The Board staff has been developing a procedure using statistical models tailored to each individual series.[3] The table on the last page compares monthly and quarterly average growth rates for the current M_1 series with those of an alternative series from the model-based approach.

Differences in seasonal adjustment techniques do not change the trend in monetary growth, but, as may be seen in the table, they do alter month-to-month growth rates owing to differing estimates of the distribution over time of the seasonal component in money behavior. Shortrun money growth is variable under both the alternative and current techniques of seasonal adjustment, illustrating the inherently large "noise" component of the series. However, the redistribution of the seasonal component under the alternative technique does on average tend to moderate month-to-month changes somewhat.

The Board will continue to publish seasonally adjusted estimates for M_1 on both current and alternative bases at least until the annual review of seasonal factors in 1983. A detailed description of the alternative method will be available shortly.

GROWTH RATES OF M_1 USING CURRENT [1] AND ALTERNATIVE [2] SEASONAL ADJUSTMENT PROCEDURES

[Monthly average—percent annual rates]

	Current	Alternative
1981		
January	9.8	1.4
February	4.3	7.5
March	14.3	16.0
April	25.2	22.6
May	−11.4	−10.3
June	−2.2	−0.6
July	2.8	2.2
August	4.8	5.3
September	0.3	3.1
October	4.7	0.0
November	9.7	11.1
December	12.4	15.4
1982		
January	21.0	11.4
February	−3.5	1.3
March	2.7	6.4
April	11.0	4.5
May	−2.4	0.5

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[1] See Committee of Experts on Seasonal Adjustment Techniques, Seasonal Adjustment of the Monetary Aggregates (Board of Governors of the Federal Reserve System, October 1981).

[2] The current seasonal adjustment technique has most recently been summarized in the description to the mimeograph release of historical money stock data dated March 1982. Detailed descriptions of the X–11 program and variants can be obtained from technical paper No. 15 of the U.S. Department of Commerce (revised February 1967) and from the report to the Board cited in footnote 1.

[3] The model-based seasonal adjustment procedures currently under review by the Board staff use methods based on the well-developed theory of statistical regression and time series modeling. These approaches allow development of seasonal factors that are more sensitive than the current factors to unique characteristics of each series, including, for example, fixed and evolving seasonal patterns, trading day effects, within-month seasonal variations, holiday effects, outlier adjustments, special events adjustments (such as the 1980 credit controls experience), and serially correlated noise components.

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GROWTH RATES OF M_1 USING CURRENT [1] AND ALTERNATIVE [2] SEASONAL ADJUSTMENT PROCEDURES—Continued

[Monthly average—percent annual rates]

	Current	Alternative
June	−1.6	1.3
Quarterly average—percent annual rates		
1981		
QI	4.6	3.5
QII	9.2	9.6
QIII	0.3	0.9
QIV	5.7	5.5
1982		
QI	10.4	9.5
QII	3.1	3.4

[1] Current monthly seasonal factors are derived using an X-11/ARIMA-based procedure applied to monthly data.

[2] Alternative monthly seasonal factors are derived using a model-based procedure applied to weekly data.

[Letter of Transmittal]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM—MIDYEAR MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
Washington, D.C., July 20, 1982.

The PRESIDENT OF THE SENATE,
The SPEAKER OF THE HOUSE OF REPRESENTATIVES,
Washington, D.C.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,

PAUL A. VOLCKER, *Chairman.*

SECTION 1: THE PERFORMANCE OF THE ECONOMY IN THE FIRST HALF OF 1982

The contraction in economic activity that began in mid-1981 continued into the first half of 1982, although at a diminished pace. Declines in production and employment slowed, while sales of automobiles improved. Real GNP fell at a 4 percent annual rate between the third quarter of 1981 and the first quarter of 1982. With output declining, the margin of unused plant capacity widened and the unemployment rate rose to a postwar record.

By mid-1982, however, the recession seemed to be drawing to a close. Inventory positions had improved substantially, homebuilding was beginning to revive, and consumer spending appeared to be rising. Nonetheless, there were signs of increased weakness in business investment. Although final demands apparently fell during the second quarter, the rate of inventory liquidation slowed, and on balance, real GNP apparently changed little. If, in fact, this spring or early summer is determined to have been the cyclical trough, both the depth and duration of the decline in activity will have been about the same as in other postwar recessions.

The progress in reducing inflation that began during 1981 continued in the first half of 1982. The greatest improvement was in prices of food and energy—which benefited from favorable supply conditions—but increases in price measures that exclude these volatile items also have slowed markedly. Moreover, increases in employment costs, which carry forward the momentum of inflation, have diminished considerably. Not only have wage increases eased for union workers in hardpressed industries as a result of contract concessions, but wage and fringe benefit increases also have slowed for non-union and white-collar workers in a broad range of industries. In addition there has been increasing use of negotiated work-rule changes as

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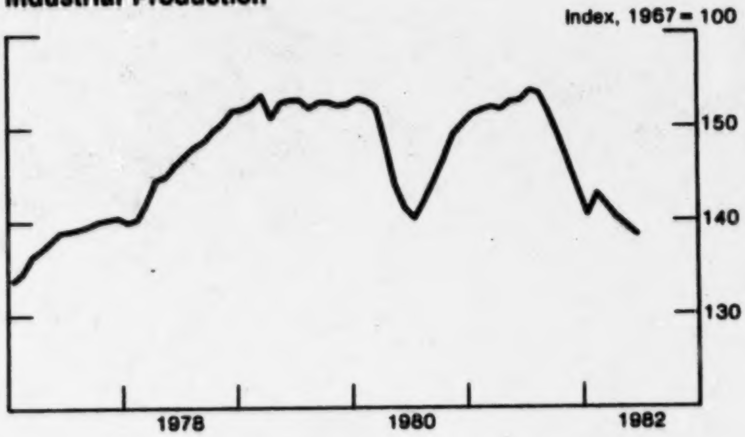
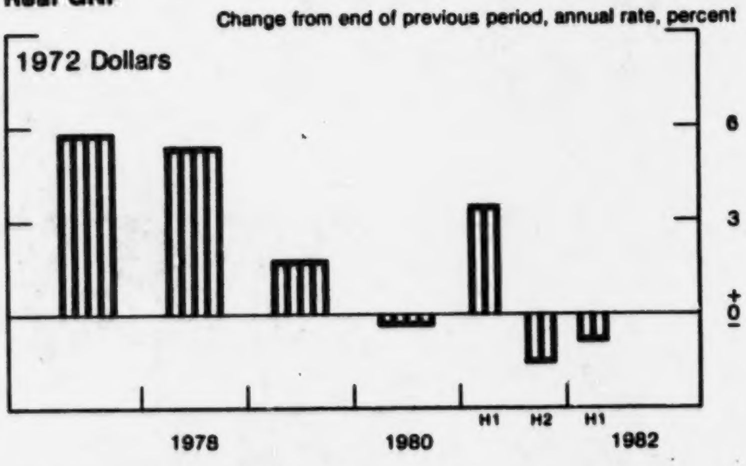
well as other efforts by business to enhance productivity and trim costs. At the same time, purchasing power has been rising; real compensation per hour increased 1 percent during 1981 and rose at about a 3 percent annual rate over the first half of 1982.

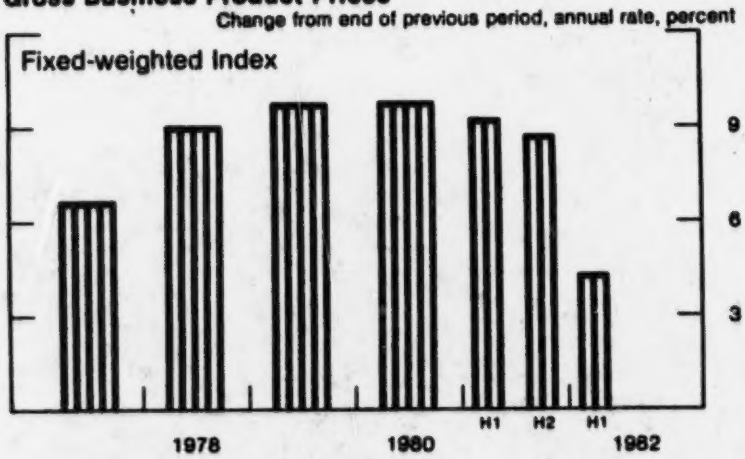
Industrial Production



Real GNP



Gross Business Product Prices



Note: Data for 1982 H1 are partially estimated by the FRB.

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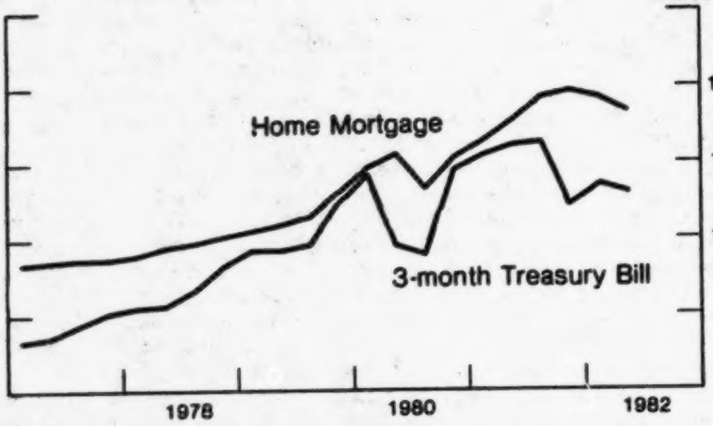
Interest rates

As the recession developed in the autumn of 1981, short-term interest rates moved down substantially. However, part of this decline was retraced at the turn of the year as the demand for money bulged and reserve positions tightened. After the middle of the first quarter, short-term rates fluctuated but generally trended downward, as money—particularly the narrow measure, M_1—grew slowly on average and the weakness in economic activity continued. In mid-July, short-term rates were distinctly below the peak levels reached in 1980 and 1981. Nonetheless, short-term rates were still quite high relative to the rate of inflation.

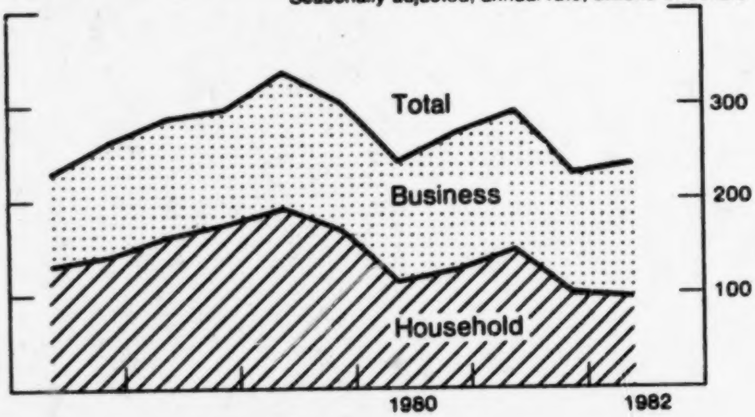
Long-term interest rates also remained high during the first half of 1982. In part, this reflected doubts by market participants that the improved price performance would be sustained over the longer run. This skepticism was related to the fact that, during the past two decades, episodes of reduced inflation have been short-lived, followed by reacceleration to even faster rates of price increase. High long-term rates also have been fostered by the prospect of huge deficits in the federal budget even as the economy recovers. Fears of deepening deficits have affected expectations of future credit market pressures, and perhaps also have sustained inflation expectations. The resolution on the 1983 fiscal year budget that was adopted by the Congress represents a beginning effort to deal with the prospect of widening deficits; and the passage of implementing legislation should work in the direction of reducing market pressures on interest rates.

Interest Rates



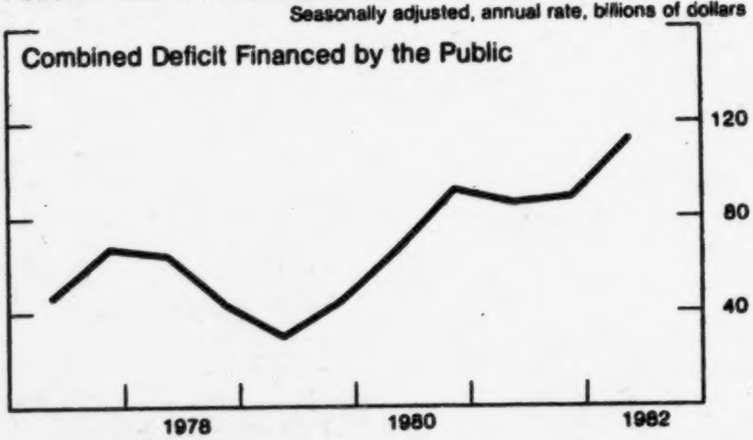
Funds Raised by Private Nonfinancial Sectors

Seasonally adjusted, annual rate, billions of dollars



Federal Government Borrowing

Seasonally adjusted, annual rate, billions of dollars



Note: Data for 1982 H1 are partially estimated by the FRB.

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Domestic credit flows

Aggregate credit flows to private non-financial borrowers increased somewhat in the first half of 1982 from the reduced pace in the second half of 1981, according to very preliminary estimates. Business borrowing rose while households reduced further their use of credit. Borrowing by the federal government increased sharply in late 1981, after the 5 percent cut in personal income tax rates, and remained near the new higher level during the first half of 1982 on a seasonally adjusted basis. Reflecting uncertainties about the future economic and financial environment, both lenders and borrowers have shown a strong preference for short-term instruments.

Much of the slackening in credit flows to nonfinancial sectors in the last part of 1981 was accounted for by households, particularly by household mortgage borrowing. Since then, mortgage credit flows have picked up slightly. The advance was encouraged in part by the gradual decline in mortgage rates from the peaks of last fall. In addition, households have made widespread use of adjustable-rate mortgages and "creative" financing techniques—including relatively short-term loans made by sellers at below-market interest rates and builder "buy-downs." About two-fifths of all conventional mortgage loans closed recently were adjustable-rate instruments, and nearly three-fourths of existing home transactions reportedly involved some sort of creative financing.

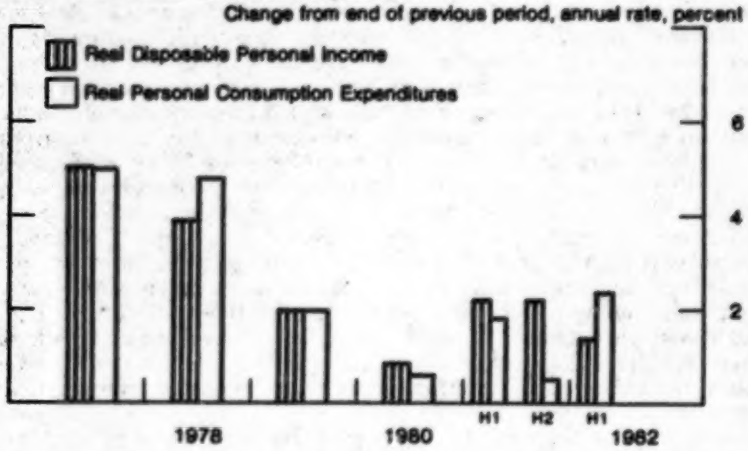
Business borrowing dropped sharply during the last quarter of 1981, primarily reflecting reduced inventory financing needs. However, credit use by nonfinancial corporations rose significantly in the first half of 1982, despite a further drop in capital expenditures. The high level of bond rates has discouraged corporations from issuing long-term debt, and a relatively large share of business borrowing this year has been accomplished in short-term markets—at banks and through sales of commercial paper. The persistently large volume of business borrowing suggests an accumulation of liquid assets as well as an intensification of financial pressures on at least some firms. Signs of corporate stress continue to mount, including increasing numbers of dividend reductions or suspensions, a rising fraction of business loans at commercial banks with interest or principal past due, and relatively frequent downgradings of credit ratings.

After raising a record volume of funds in U.S. credit markets in 1981, the federal government continued to borrow at an extraordinary pace during the first half of 1982, as receipts (national income and product accounts basis) fell while expenditures continued to rise. Owing to the second phase of the tax cut that went into effect on July 1 and the effects on tax revenues of the recession and reduced inflation, federal credit demands will expand further in the period ahead.

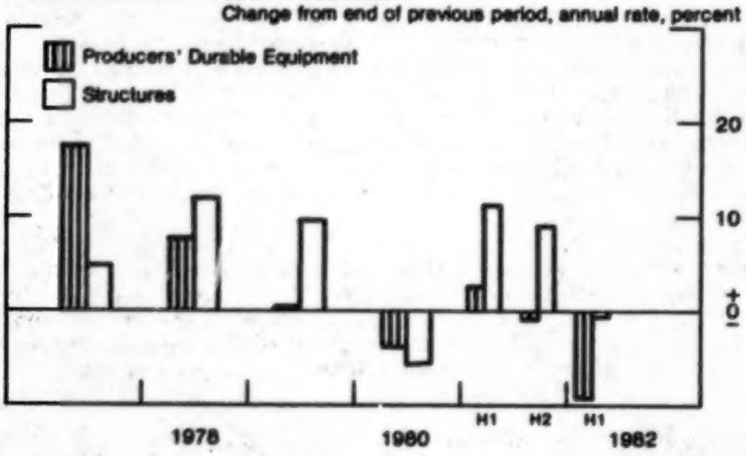
Consumption

Personal consumption expenditures (adjusted for inflation) fell sharply in the fourth quarter of 1981, but turned up early in 1982 and apparently strengthened further during the second quarter. The weakness in consumer outlays during the fourth quarter was concentrated in the auto sector, as total sales fell to an annual rate of 7.4 million units—the lowest quarterly figure in more than a decade—and sales of domestic models plummeted to a 5.1 million unit rate.

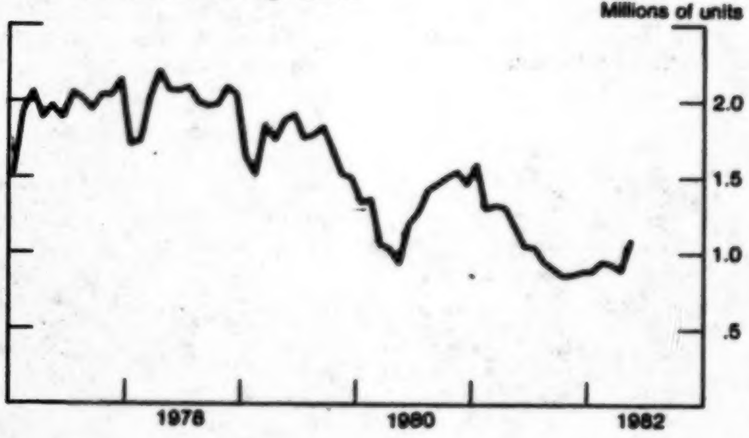
Real Income and Consumption



Real Business Fixed Investment



Total Private Housing Starts



Note: Data for 1982 H1 are partially estimated by the FRB.

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Price rebates and other sales promotion programs during the early months of 1982 provided a fillip to auto demand, and sales climbed to an 8.1 million unit rate. Auto markets remained firm into the spring, boosted in part by various purchase incentives. But as has generally occurred when major promotions have ended, auto purchases fell sharply in June. Outside the auto sector, retail sales at most types of stores were up significantly for the second quarter as a whole. Even purchases at furniture and appliance outlets, which had been on a downtrend since last autumn, increased during the spring.

Real after-tax income has continued to edge up, despite the sharp drop in output during the recession. The advance reflects not only typical cyclical increases in transfer payments but also the reduction in personal income tax rates on October 1. Households initially saved a sizable proportion of the tax cut, boosting the personal saving rate from 5¼ percent in mid-1981—about equal to the average of the late 1970s and early 1980s—to 6.1 percent in the fourth quarter of 1981. During early 1982, however, consumers increased spending, partly to take advantage of price markdowns for autos and apparel, and the saving rate fell.

Business investment

As typically occurs during a recession, the contraction in business fixed investment has lagged behind the decline in overall activity. Indeed, even though real GNP dropped substantially during the first quarter of 1982, real spending for fixed business capital actually rose a bit. An especially buoyant element of the investment sector has been outlays for nonfarm buildings—most notably, commercial office buildings, for which appropriations and contracts often are set a year or more in advance.

In contrast to investment in structures, business spending for new equipment showed little advance during 1981 and weakened considerably in the first half of 1982. Excluding business purchases of new cars, which also were buoyed by rebate programs, real investment in producers' durable equipment fell at a 2 percent annual rate in the first quarter. The decline evidently accelerated in the second quarter. In April and May, shipments of nondefense capital goods, which account for about 80 percent of the spending on producers' durable equipment, averaged nearly 3 percent below the first-quarter level in nominal terms. Moreover, sales of heavy trucks dropped during the second quarter to a level more than 20 percent below the already depressed first-quarter average.

Businesses liquidated inventories at a rapid rate during late 1981 and in the first half of 1982. The adjustment of stocks followed a sizable buildup during the summer and autumn of last year that accompanied the contraction of sales. The most prominent inventory overhang by the end of 1981 was in the automobile sector as sales fell precipitously. However, with a combination of production cutbacks and sales promotions, the days' supply of unsold cars on dealers lots had improved considerably by spring.

Manufacturers and non-auto retailers also found their inventories rising rapidly last autumn. Since then, manufacturers as a whole have liquidated the accumulation that occurred during 1981, although some problem areas still exist—particularly in primary metals. Stocks held by non-auto retailers have been brought down from their cyclical peak, but they remain above pre-recession levels.

Residential construction

Housing activity thus far in 1982 has picked up somewhat from the depressed level in late 1981. Housing starts during the first five months of 1982 were up 10 percent on average from the fourth quarter of 1981. The improvement in homebuilding has been supported by strong underlying demand for housing services in most markets and by the continued adaptation of real estate market participants to nontraditional financing techniques that facilitate transactions.

The turnaround in housing activity has not occurred in all areas of the country. In the south, home sales increased sharply in the first part of 1982, and housing starts rose 25 percent from the fourth quarter of 1981. In contrast, housing starts declined further, on average, during the first five months of 1982 in both the west and the industrial north central states.

Government

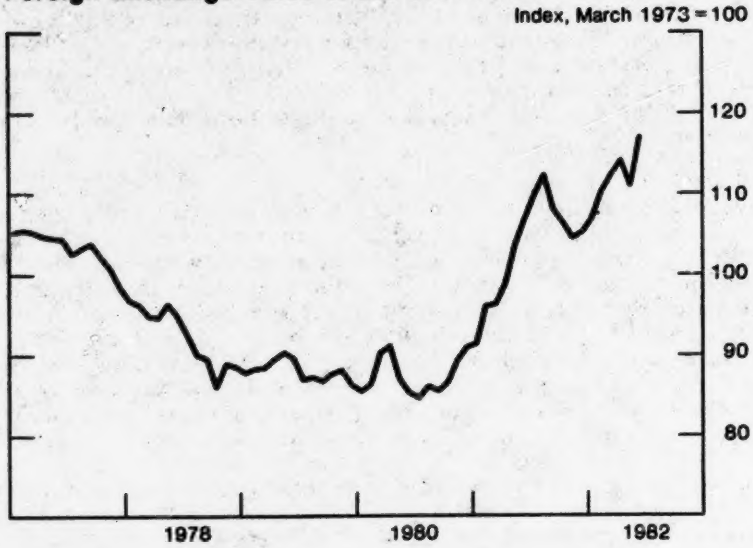
Federal government purchases of goods and services, measured in constant dollars, declined over the first half of 1982. The decrease occurred entirely in the nondefense area, primarily reflecting a sharp drop in the rate of inventory accumulation by the Commodity Credit Corporation during the spring quarter. Purchases by the Commodity Credit Corporation had reached record levels during the previous two quarters owing to last summer's large harvests and weak farm prices. Other nondefense outlays fell slightly over the first half of the year as a result of cuts in employment and other expenditures under many programs. Real defense spending apparently rose over the first half of the year, and the backlog of unfilled orders grew further. The federal deficit on a national income and product account basis widened from $100 billion at the end of 1981 to about $130 billion during the spring of this year. Much of this increase in the deficit reflects the effects of the recession on federal expenditures and receipts.

At the state and local goverment level, real purchases of goods and services fell further over the first half of 1982 after having declined 2 percent during 1981. Most of the weakness this year has been in construction outlays as employment levels have stabilized after large reductions in the federally funded CETA program led to sizable layoffs last year. The declines in state and local government activity in part reflect fiscal strains associated with the withdrawal of federal support for many activities and the effects of cyclically sluggish income growth on tax receipts. Because of the serious revenue problems, several states have increased sales taxes and excise taxes on gasoline and alcohol.

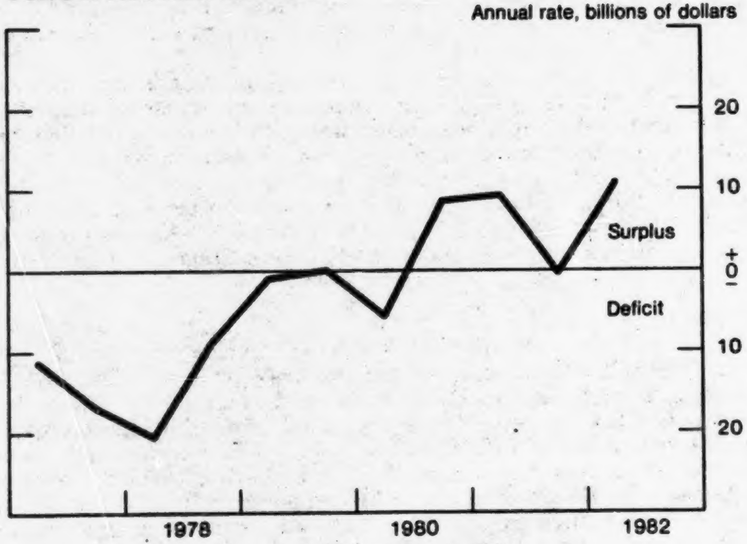
International payments and trade

The weighted-average value of the dollar, after declining about 10 percent from its peak last August, began to strengthen sharply again around the beginning of the year and since then has appreciated nearly 15 percent on balance. The appreciation of the dollar has been associated to a considerable extent with the declining inflation rate in the United States and the rise in dollar interest rates relative to yields on assets denominated in foreign currencies.

Foreign Exchange Value of the U.S. Dollar



Current Account Balance



Note: Data for 1982 H1 are partially estimated by the FRB.

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Reflecting the effects of the strengthening dollar, as well as the slowing of economic growth abroad, real exports of goods and services have been decreasing since the beginning of 1981. The volume of imports other than oil, which rose fairly steadily throughout last year, dropped sharply in the first half of 1982, owing to the weakness of aggregate demand—especially for inventories—in the United States. In addition, both the volume and price of imported oil fell during the first half of the year. The current account, which was in surplus for 1981 as a whole, recorded another surplus in the first half of this year as the value of imports fell more than the value of exports.

Labor markets

Employment has declined by nearly 1½ million since the peak reached in mid-1981. As usually happens during a cyclical contraction, the largest job losses have been in durable goods manufacturing industries—such as autos, steel, and machinery—as well as at construction sites. The job losses in manufacturing and construction during this recession follow a limited recovery from the 1980 recession; as a result, employment levels in these industries are more than 10 percent below their 1979 highs. In addition, declines in aggregate demand have tempered the pace of hiring at service industries and trade establishments over the past year. As often happens near a business cycle trough, employment fell faster than output in early 1982 and labor productivity showed a small advance after declining sharply during the last half of 1981.

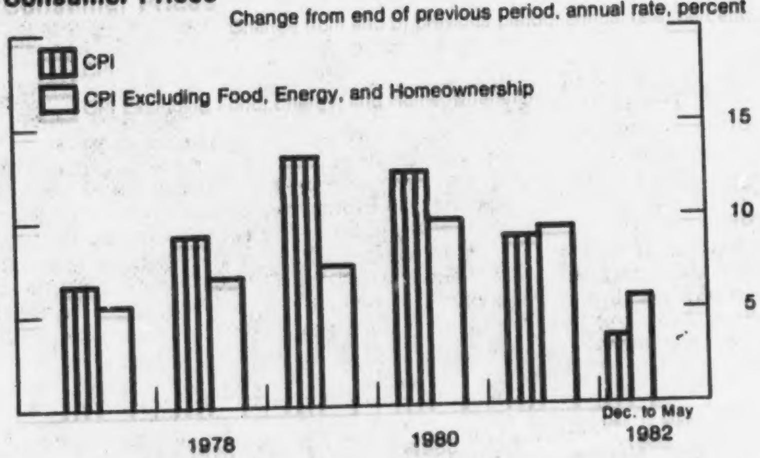
Since mid-1981 there has been a 2¼ percentage point rise in the overall unemployment rate to a postwar record high of 9½ percent. The effects of the recession have been most severe in the durable goods and construction industries, and the burden of rising unemployment has been relatively heavy on adult men, who tend to be more concentrated in these industries. At the same time, joblessness among young and inexperienced workers remains extremely high; hardest hit have been black male teenagers who experienced an unemployment rate of nearly 60 percent in June 1982.

Reflecting the persistent slack in labor markets, most indicators of labor supply also show a significant weakening. For example, the number of discouraged workers—that is, persons who report that they want work but are not looking for jobs because they believe they cannot find any—has increased by nearly half a million over the past year, continuing an upward trend that began before the 1980 recession. In addition, the labor force participation rate—the proportion of the working-age population that is employed or actively seeking jobs—has been essentially flat for the last two years after rising about one-half percentage point annually between 1975 and 1979.

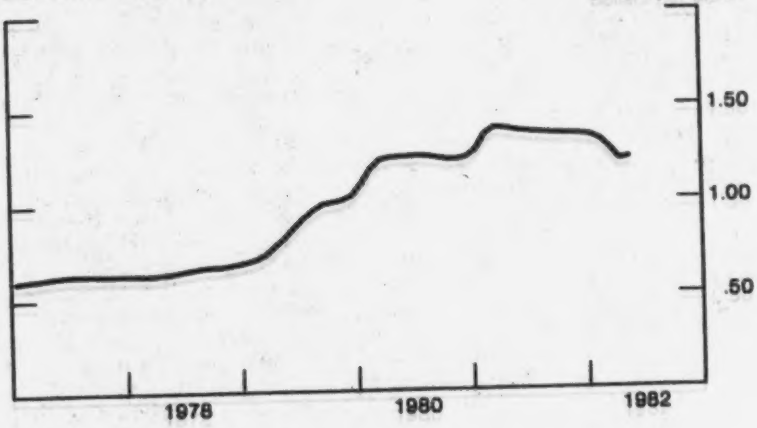
Prices and labor costs

A slowing in the pace of inflation, which was evident during 1981, continued through the first half of this year. During the first five months of 1982 (the latest data available), the consumer price index increased at an annual rate of 3.5 percent, sharply lower than the 8.9 percent rise during 1981. Much of the improvement was in energy and food prices as well as in the volatile CPI measure of homeownership costs. But even excluding these items, the annual rate of increase in consumer prices has slowed to 5½ percent this year compared with a 9½ percent rise last year. The moderation of price increases also was evident at the producer level. Prices of capital equipment have increased at a 4¼ percent annual rate thus far this year—well below the 9¼ percent pace of 1981. In addition, the decline in raw materials prices, which occurred throughout last year, has continued in the first half of 1982.

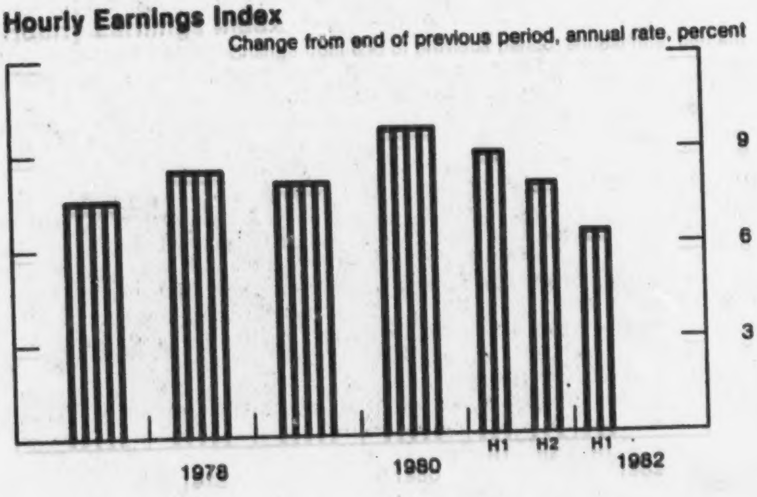
Consumer Prices



Gasoline Prices



Hourly Earnings Index



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Gasoline prices at the retail level, which had remained virtually flat over the second half of 1981, fell substantially during the first four months of 1982. Slack domestic demand and an overhang of stocks on world petroleum markets precipitated the decline in prices. However, gasoline prices began to rise again in May in reflection of rising consumption, reduced stocks, and lower production schedules by major crude oil suppliers.

The rate of increase in employment costs decelerated considerably during the first half of 1982. The index of average hourly earnings, a measure of wage trends for production and nonsupervisory personnel, rose at a 6¼ percent annual rate over the first half of this year, compared with an increase of 8¼ percent during 1981. Part of the slowing was due to early negotiation of expiring contracts and renegotiation of existing contracts in a number of major industries. These wage concessions are expected to relieve cost pressures and to enhance the competitive position of firms in these industries. Increases in fringe benefits, which generally have risen faster than wages over the years, also are being scaled back. Because wage demands, not to mention direct escalator provisions, are responsive to price performance, the progress made in reducing the rate of inflation should contribute to further moderation in labor cost pressures.

SECTION 2: THE GROWTH OF MONEY AND CREDIT IN THE FIRST HALF OF 1982

The annual targets for the monetary aggregates announced in February were chosen to be consistent with continued restraint on the growth of money and credit in order to exert sustained downward pressure on inflation. At the same time, these targets were expected to result in sufficient money growth to support an upturn in economic activity. Measured from the fourth quarter of 1981 to the fourth quarter of 1982, the growth ranges for the aggregates adopted by the Federal Open Market Committee (FOMC) were as follows: for M_1, 2½ to 5½ percent; for M_2, 6 to 9 percent; and for M_3, 6½ to 9½ percent. The corresponding range specified by the FOMC for bank credit was 6 to 9 percent.[1]

When the FOMC was deliberating on its annual targets in February, the Committee was aware that M_1 already had risen well above its average level in the fourth quarter of 1981. In light of the financial and economic backdrop against which the bulge in M_1 had occurred, the Committee believed it likely that there had been an upsurge in the public's demand for liquidity. It also seemed probable that this strengthening of money demand would unwind in the months ahead. Thus, under these circumstances and given the relatively low base for the M_1 range for 1982, it did not appear appropriate to seek an abrupt return to the annual target range, and the FOMC indicated its willingness to permit M_1 to remain above the range for a while. At the same time, the FOMC agreed that the expansion in M_1 for the year as a whole might appropriately be in the upper part of its range, particularly if available evidence suggested the persistence of unusual desires for liquidity that had to be accommodated to avoid undue financial stringency.

In setting the annual target for M_2, the FOMC indicated that M_2 growth for the year as a whole probably would be in the upper part of its annual range and might slightly exceed the upper limit. The Committee anticipated that demands for the assets included in M_2 might be enhanced by new tax incentives such as the broadened eligibility for IRA/Keogh accounts, or by further deregulation of deposit rates. The Committee expected that M_3 growth again would be influenced importantly by the pattern of business financing and, in particular, by the degree to which borrowing would be focused in markets for short-term credit.

As anticipated—and consistent with the FOMC's short-run targets—the surge in M_1 growth in December and January was followed by appreciably slower growth. After January, M_1 increased at an annual rate of only 1¼ percent on average, and the level of M_1 in June was only slightly above the upper end of the Committee's annual growth range. From the fourth quarter of 1981 to June, M_1 increased at a 5.6 percent annual rate. M_2 growth so far this year also has run a bit above the FOMC's annual range; from the fourth quarter of 1981 through June, M_2 increased on average at a 9.4 percent annual rate. From a somewhat longer perspective, M_1 has increased at a 4.7 percent annual rate, measuring growth from the first half of 1981 to the first half of 1982 and abstracting from the shift into NOW accounts in 1981; and M_2 has grown at a 9.7 percent annual rate on a half-year over half-year basis.

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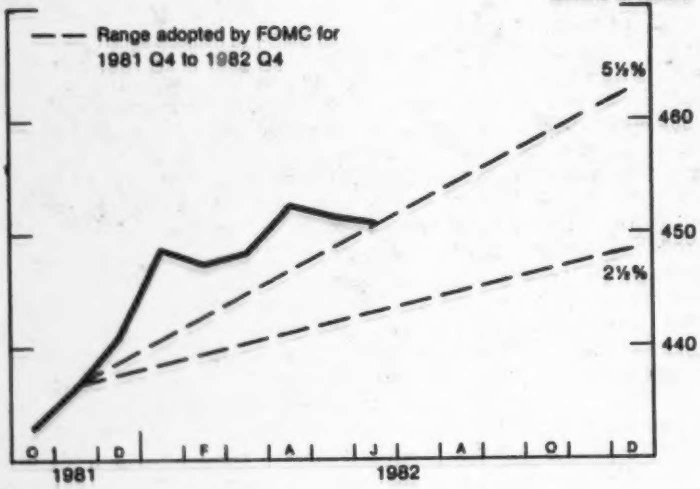
[1] Because of the authorization of international banking facilities (IBF's) on Dec. 3, 1981, the bank credit data starting in December 1981 are not comparable with earlier data. The target for bank credit was put in terms of annualized growth measured from the average of December 1981 and January 1982 to the average level in the fourth quarter of 1982 so that the shift of assets to IBF's that occurred at the turn of the year would not have a major impact on the pattern of growth.

Ranges and Actual Monetary Growth

M1



Annual Rates of Growth

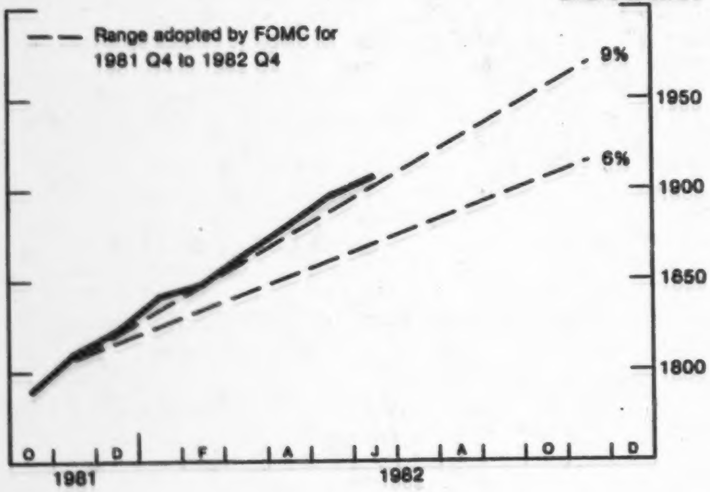
1981 Q4 to June
5.6 Percent

1981 Q4 to 1982 Q2
6.8 Percent

1981 H1 to 1982 H1
4.7 Percent[1]

[1] Adjusted for shifts into new NOW accounts in 1981.

M2



Annual Rates of Growth

1981 Q4 to June
9.4 Percent

1981 Q4 to 1982 Q2
9.7 Percent

1981 H1 to 1982 H1
9.7 Percent

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Although M_1 growth has been moderate on balance thus far this year, that growth has considerably exceeded the pace of increase in nominal GNP. Indeed, the first-quarter decline in the income velocity of M_1—that is, GNP divided by M_1—was extraordinarily sharp. Similarly, the velocity of the broader aggregates has been unusually weak. Given the persistence of high interest rates, this pattern of velocity behavior suggests a heightened demand for M_1 and M_2 over the first half.

The unusual demand for M_1 has been focused on its NOW account component. Following the nationwide authorization of NOW accounts at the beginning of 1981, the growth of such deposits surged. When the aggregate targets were reviewed this past February, a variety of evidence indicated that the major shift from conventional checking and savings accounts into NOW accounts was over; in particular, the rate at which new accounts were being opened had dropped off considerably. As a result of that shift, however, NOW accounts and other interest-bearing checkable deposits had grown to account for almost 20 percent of M_1 by the beginning of 1982. Subsequently, it has become increasingly apparent that M_1 is more sensitive to changes in the public's desire to hold highly liquid assets.

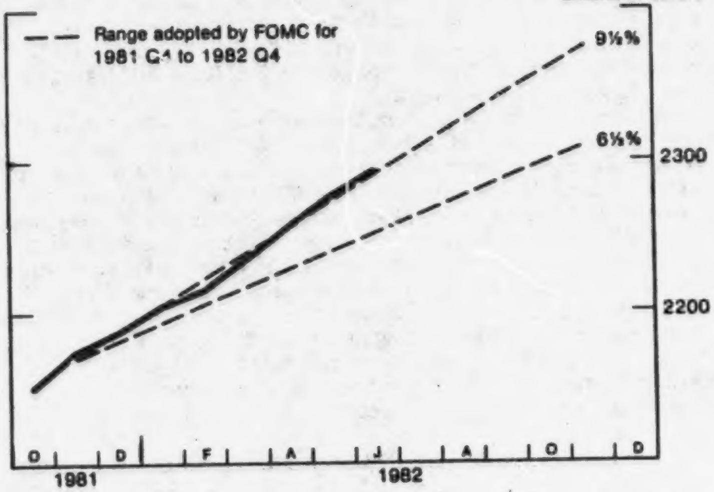
M_1 is intended to be a measure of money balances held primarily for transaction purposes. However, in contrast to the other major components of M_1—currency and conventional checking accounts—NOW accounts also have some characteristics of traditional savings accounts. Apparently reflecting precautionary motives to a considerable degree, NOW accounts and other interest-bearing checkable deposits grew surprisingly rapidly in the fourth quarter of last year and the first quarter of this year. Although growth in this component has slowed recently, its growth from the fourth quarter of last year to June has been 30 percent at an annual rate. The other components of M_1 increased at an annual rate of less than 1 percent over this same period.

Looking at the components of M_2 not also included in M_1, the so-called nontransaction components, these items grew at a 10¾ percent annual rate from the fourth quarter to June. General purpose and broker/dealer money market mutual funds were an especially strong component of M_2, increasing at almost a 30 percent annual rate this year. Compared with last year, however, when the assets of such money funds more than doubled, this year's increase represents a sharp deceleration.

Perhaps the most surprising development affecting M_2 has been the behavior of conventional savings deposits. After declining in each of the past four years—falling 16 percent last year—savings deposits have increased at about a 4 percent annual rate thus far this year. This turnaround in savings deposit flows, taken together with the strong increase in NOW accounts and the still substantial growth in money funds, suggests that stronger preferences to hold safe and highly liquid financial assets in the current recessionary environment are bolstering the demand for M_2 as well as M_1.

Ranges and Actual Monetary Growth

M3



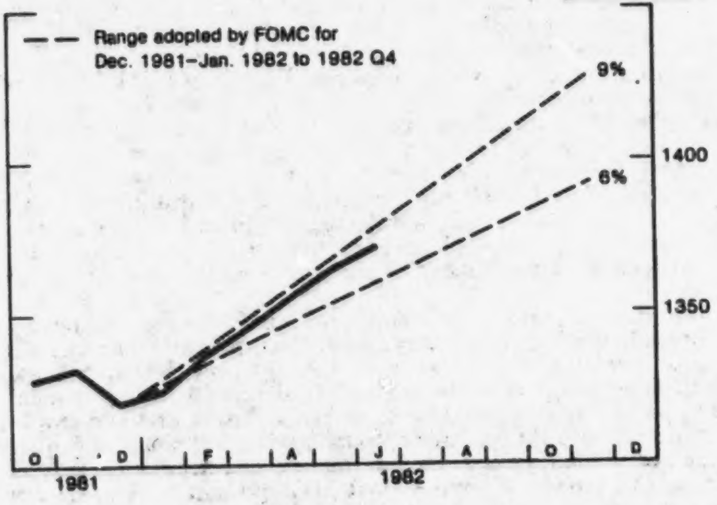
Annual Rates of Growth

1981 Q4 to June
9.7 Percent

1981 Q4 to 1982 Q2
9.8 Percent

1981 H1 to 1982 H1
10.5 Percent

Bank Credit



Annual Rates of Growth

Dec.–Jan. to June
8.0 Percent

Dec.–Jan. to 1982 Q2
8.3 Percent

1981 H1 to 1982 H1
8.4 Percent[1]

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[1] Adjusted for initial shifts into international banking facilities.

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M_3 increased at a 9.7 annual rate from the fourth quarter of 1981 to June, just above the upper end of the FOMC's annual growth target. Early in the year, M_3 growth was relatively moderate as a strong rise in large denomination CDs was offset by declines in term RPs and in money market mutual funds restricted to institutional investors. During the second quarter, however, M_3 showed a larger increase; the weakness in its term RP and money fund components subsided and heavy issuance of large CDs continued. With growth of "core deposits" relatively weak on average, commercial banks borrowed heavily in the form of large CDs to fund the increase in their loans and investments.

Commercial bank credit grew at an 8.3 percent annual rate over the first half of the year, in the upper part of the FOMC's range for 1982. Bank loans have increased on average at about a 9½ percent annual rate, with loans to nonfinancial businesses expanding at a 14 percent annual rate. In past economic downturns, business loan demand at banks has tended to weaken, but consistently high long-term interest rates in the current recession have induced corporations to meet the great bulk of their external financing needs through short-term borrowing. Real estate loans have increased at a 7¼ percent annual rate this year, somewhat slower than the growth in each of the past two years. Consumer loans outstanding during the first half of the year have grown at the same sluggish pace of 3 percent experienced last year. The investment portfolios of banks have expanded at about a 5 percent annual rate, with the rate of increase in U.S. government obligations about twice as large as the growth in holdings of other types of securities.

SECTION 3: THE FEDERAL RESERVE'S OBJECTIVES FOR GROWTH OF MONEY AND CREDIT

There is a clear need today to promote higher levels of production and employment in our economy. The objective of Federal Reserve policy is to create an environment conducive to sustained recovery in business activity while maintaining the financial discipline needed to restore reasonable price stability. The experience of the past two decades has amply demonstrated the destructive impact of inflation on economic performance. Because inflation cannot persist without excessive monetary expansion, appropriately restrained growth of money and credit over the longer run is critical to achieving lasting prosperity.

The policy of firm restraint on monetary growth has contributed importantly to the recent progress toward reducing inflation. But when inflationary cost trends remain entrenched, the process of slowing monetary growth can entail economic and financial stresses, especially when so much of the burden of dealing with inflation rests on monetary policy. These strains—reflected in reduced profits, liquidity problems, and balance-sheet pressures—place particular hardships on industries that depend heavily on credit markets such as construction, business equipment, and consumer durables.

Unfortunately, these stresses cannot be easily remedied through accelerated money growth. The immediate effect of encouraging faster growth in money might be lower interest rates, especially in short-term markets. In time, however, the attempt to drive interest rates lower through a substantial reacceleration of money growth would founder, for the result would be to embed inflation and expectations of inflation even more deeply into the nation's economic system. It would mean that this recession was another wasted, painful episode instead of a transition to a sustained improvement in the economic environment. The present and prospective pressures on financial markets urgently need to be eased not by relaxing discipline on money growth, but by the adoption of policies that will ensure a lower and declining federal deficit. Moreover, a return to financial health will require the adoption of more prudent credit practices on the part of private borrowers and lenders alike.

In reviewing its targets for 1982 and setting tentative targets for 1983, the FOMC had as its basic objective the maintenance of the longer-range thrust of monetary discipline in order to reduce inflation further, while providing sufficient money growth to accommodate exceptional liquidity pressures and support a sustainable recovery in economic activity. At the same time, the Committee recognized that regulatory actions or changes in the public's financial behavior might alter the implications of any quantitative monetary goals in ways that cannot be fully predicted.

In light of all these considerations, the Committee concluded that a change in the previously announced targets was not warranted at this time. Because of the tendency for the demand for money to run strong on average in the first half, and also responding to the congressional budget resolution, careful consideration was given to the question of whether some raising of the targets was in order. However, the available evidence did not suggest that a large increase in the ranges was justified, and a small change in the ranges would have represented a degree of "fine tuning" that appeared inconsistent with the degree of uncertainty surrounding the precise relationship of money to other economic variables at this time. However, the Committee concluded, based on current evidence, that growth this year around the top of the ranges for the various aggregates would be acceptable.

The Committee also agreed that possible shifts in the demand for liquidity in current economic circumstances might require more than ordinary elements of flexibility and judgment in assessing appropriate needs for money in the months ahead. In the near term, measured growth of the aggregates may be affected by the income tax reductions that occurred on July 1, by cost-of-living increases in social security benefits, and by the ongoing difficulties of accurately accounting for seasonal movements in the money stock. But more fundamentally, it is unclear to what degree businesses and households may continue to wish to hold unusually large precautionary liquid balances. To the extent the evidence suggests that relatively strong precautionary demands for money persist, growth of the aggregates somewhat above their targeted ranges would be tolerated for a time and still would be consistent with the FOMC's general policy thrust.

Looking ahead to 1983 and beyond, the FOMC remains committed to restraining money growth in order to achieve sustained noninflationary economic expansion. At this point, the FOMC feels that the ranges now in effect can appropriately remain as preliminary targets for 1983. Because monetary aggregates in 1982 more likely than not will be close to the upper ends of their ranges, or perhaps even somewhat above them, the preliminary 1983 targets would be fully consistent with a reduction in the actual growth of money in 1983.

In light of the unusual uncertainty surrounding the economic, financial, and budgetary outlook, the FOMC stressed the tentative nature of its 1983 targets. On the one hand, postwar cyclical experience strongly suggests that some reversal of this year's unusual shift in the asset-holding preferences of the public could be expected; with economic activity on an upward trend, any lingering precautionary motives for holding liquid balances should begin to fade, thus contributing to a rapid rise in the velocity of money. Moreover, regulatory actions by the Depository Institutions Deregulation Committee that increase the competitive appeal of deposit instruments—as well as the more widespread use of innovative cash management techniques, such as "sweep" accounts—also could reduce the demand for money relative to income and interest rates. On the other hand, factors exist that should increase the attractiveness of holding cash balances. The long upward trend in the velocity of money since the 1950s took place in an environment of rising inflation and higher nominal interest rates—developments that provide incentives for economizing on money holdings. As these incentives recede, it is possible that the attractiveness of cash holdings will be enhanced and that more money will be held relative to the level of business activity.

SECTION 4: THE OUTLOOK FOR THE ECONOMY

The economy at midyear appears to have leveled off after sizable declines last fall and winter. Consumption has strengthened with retail sales up significantly in the second quarter. New and existing home sales have continued to fluctuate at depressed levels, but housing starts nonetheless have edged up. In the business sector, substantial progress has been made in working off excess inventories, and the rate of liquidation appears to have declined. On the negative side, however, plant and equipment spending, which typically lags an upturn in overall activity, is still depressed. And the trend in export demand continues to be a drag on the economy, reflecting the dollar's strength and weak economic activity abroad.

An evaluation of the balance of economic forces indicates that an upturn in economic activity is highly likely in the second half of 1982. Monetary growth along the lines targeted by the FOMC should accommodate this expansion in real GNP, given the increases in velocity that typically occur early in a cyclical recovery and absent an appreciable resurgence of inflation. The 10 percent cut in income tax rates that went into effect July 1 is boosting disposable personal income and should reinforce the growth in consumer spending. Given the improved inventory situation, any sizable increase in consumer spending should, in turn, be reflected in new orders and a pickup in production. Another element supporting growth in real GNP will be the continuing rise in defense spending and the associated private investment outlays needed for the production of defense equipment.

At least during the initial phase, the expansion is likely to be more heavily concentrated in consumer spending than in past business cycles, as current pressures in financial markets and liquidity strains may inhibit the recovery in investment activity. With mortgage interest rates high, residential construction does not seem likely to contribute to the cyclical recovery to the extent that is has in the past. Likewise, the high level of corporate bond rates, and the cumulative deterioration in corporate balance sheets resulting from reliance in recent years on short-term borrowing, may restrain capital spending, especially given the considerable margin of unutilized capacity that now exists.

The excellent price performance so far this year has been helped by slack demand and by exceptionally favorable energy and food supply developments. For that reason, the recorded rate of inflation may be higher in the second half. However, prospects appear excellent for continuing the downtrend in the underlying rate of inflation. As noted earlier, significant progress has been made in slowing the rise in labor compensation, and improvements in underlying cost pressures should continue over the balance of the year. Unit labor costs also are likely to be held down by a cyclical rebound in productivity growth as output recovers. Moreover, lower inflation will contribute to smaller cost-of-living wage adjustments, which will moderate cost pressures further.

The Federal Reserve's objectives for money growth through the end of 1983 are designed to be consistent with continuing recovery in economic activity. A critical factor influencing the composition and strength of the expansion will be the extent to which pressures in financial markets moderate. This, in turn, depends importantly on the progress made in further reducing inflationary pressures. A marked decrease in inflation would take pressure off financial markets in two ways. First, slower inflation will lead to a reduced growth in transaction demands for money, given any particular level of real activity. It follows that a given target for money growth can be achieved with less pressure on interest rates and accordingly less restraint on real activity, the greater is the reduction in inflation. Second, further progress in curbing inflation will help lower long-term interest rates by reducing the inflation premium contained in nominal interest rates. The welcome relief in inflation seen recently apparently is assumed by many to represent a cyclical rather than a sustained drop in inflation. But the longer that improved price performance is maintained, the greater will be the confidence that a decisive downtrend in inflation is being achieved. Such a change should be reflected in lower long-term interest rates and stronger activity in the interest-sensitive sectors of the economy.

Another crucial influence on financial markets and thus on the nature of the expansion in 1983 will be the federal budgetary decisions that are made in coming months. The budget resolution that was recently passed by the House and Senate is a constructive first step in reducing budget deficits as the economy recovers. However, much remains to be done in appropriation and revenue legislation to implement this resolution. How the budgetary process unfolds will be an important factor in determining future credit demands by the federal government and thus the extent to which deficits will preempt the net savings generated by the private economy. A strong program of budget restraint would minimize pressures in financial markets and thereby enhance the prospects for a more vigorous recovery in homebuilding, business fixed investment, and other credit-dependent sectors.

In assessing the economic outlook, the individual members of the FOMC have formulated projections for several key measures of economic performance that fall generally within the ranges in the table below. In addition to the monetary aggregate objectives discussed earlier, these projections assume that the federal budget will be put on a course that over time will result in significant reductions in the federal deficit.

ECONOMIC PROJECTIONS OF FOMC MEMBERS

	Actual—1981	Projected	
		1982	1983
Changes, 4th quarter to 4th quarter, percent:			
Nominal GNP	9.8	5½ to 7½	7 to 9½.
Real GNP	.9	½ to 1½	2½ to 4.
GNP deflator	8.9	4¾ to 6	4 to 5¾.
Average level in the 4th quarter, percent: Unemployment rate	8.3	9 to 9¾	8½ to 9½.

Revised administration forecasts for the economy were not available at the time of the Committee's deliberation. Our understanding, however, is that the administration's midyear budgetary review will be presented within the framework of the economic assumptions used in the first budget resolution. For the remainder of 1982, those assumptions imply somewhat more rapid recovery than the range now thought most likely by members of the FOMC, but would be consistent with the monetary targets outlined in this report on the assumption of growth in velocity characteristic of the early stages of a number of past recoveries. Looking further ahead, the Committee members, like the administration and the Congress, foresee continued economic expansion in 1983, but currently anticipate a less rapid rate of price increase and somewhat slower real growth than the assumptions underlying the budget. The monetary targets tentatively set for 1983, which will be reviewed early next year, would imply, under the budgetary assumptions, relatively high growth in velocity.

The **CHAIRMAN**. Thank you very much, Mr. Chairman.

Since you started your testimony we have had additional Senators come in, and although I would like to proceed with the questioning I would ask if any members who have joined us since Chairman Volcker started his testimony would like to take just 2 minutes for any sort of an opening statement.

If not, we will proceed with the question period.

Senator Sarbanes, do you have any opening comments?

Senator **SARBANES**. I'll wait until after the questioning period.

The **CHAIRMAN**. Senator Tower.

Senator **TOWER**. Mr. Chairman, I have an opening statement I'd like to file for the record.

The **CHAIRMAN**. All right, it will be filed for the record.

OPENING STATEMENT OF SENATOR TOWER

Senator **TOWER**. Mr. Chairman, I would like to congratulate you for the courage you have shown since assuming your office. In my view, this Government and the American people owe you far more than we understand or will acknowledge.

In the face of skyrocketing Government spending, you and your fellow Governors have been the only component of government willing to do what is right rather than what is politically popular.

We have all watched as you struggled with the effects of spiraling, and seemingly permanent, inflation. We have seen how this inflation perverted traditional monetary policy theory to the point where both increases and decreases in the money stock meant higher interest rates. We have seen your courageous movement from interest rate targeting to monetary aggregate targeting, just at the time when institutional changes made all of the old definitions of money obsolete. We have seen you move from very volatile monetary growth to the recent period of relative stability. Most importantly, Mr. Chairman, we have seen you exercise the courage to wring the inflation, which is at the bottom of all of this, out of our economy.

In doing all of this, you resisted enormous political pressures, and thank God you did. In my view, it is only your independence which gives you the necessary freedom to avert the overwhelming pressures to which Congress is so susceptible. I shudder to think what condition this economy would be in today if we managed monetary policy with the same dispassionate skill with which we manage fiscal policy.

The **CHAIRMAN**. Senator Sasser.

Senator **SASSER**. Mr. Chairman, I'll submit my statement for the record.

OPENING STATEMENT OF SENATOR SASSER

Senator **Sasser**. Chairman Volcker, before I ask you some questions for the record let me be very frank with you.

I regard the Federal Reserve Board's monetary policy as a chief cause of our current economic problems.

High interest rates and tight money are crushing the life out of our economy.

High interest rates have devestated the housing industry.

We are only building one-half the houses we need every year to house a growing and changing population.

High interest rates have crucified the small businessman.

Business failures totaled just over 17,000 last year. This year we will witness 22,000 small business failures—a level that exceeds that recorded in 1933.

High interest rates are slamming the brakes on our economic growth.

We are using only 70.8 percent of our manufacturing capacity, and real gross national product in 1982 may be no higher than the real gross national product recorded in 1979, the year in which the Federal Reserve Board's monetary policies went into effect.

Indeed, in your report to the committee you note that the contraction in our economy that began in 1981 is continuing through 1982. And your whole report gives little indication that the Federal Reserve Board is prepared to adopt a new monetary policy that will stimulate economic growth.

It is my contention that the Federal Reserve Board's monetary policies are leading us to the brink of economic chaos.

I have expressed serious reservations about the Board's interest rate policies ever since they were adopted in 1979.

I expressed these reservations to President Carter, and I have, on several occasions, offered legislation that would revise the Board's tight money policies.

Chairman Volcker, the independence of the Federal Reserve Board does not give it the right to wreak havoc with the American economy.

The Board has a legal, and I would argue, a moral obligation to help the economy grow.

The Board has failed to meet this obligation by almost any reasonable standard.

The economic carnage caused by the Board's high interest rate policies must stop.

The Board must, either voluntarily or by congressional direction, revise its monetary policies to permit greater monetary growth that will bring interest rates down and make credit more affordable to American consumers and American businessmen.

The **Chairman**. Thank you very much.

Mr. Schmitt.

OPENING STATEMENT OF SENATOR SCHMITT

Senator **Schmitt**. Mr. Chairman, when you get to the questions, I hope I will have that opportunity.

Mr. Chairman, I just wanted to welcome you once again to the committee and tell you, since we last spoke, I like many others have had to reevaluate my analysis of the economy.

I must say I was one of those at the first of the year that felt if we held inflation down significantly from where it had been in 1979 and 1980 before the new economic policies were put into place, that we would see an easing of interest rates.

Clearly, the feel the investor has of 13 percent inflation is still there. The deficits are still there and greater; there is, I think, some concern that money growth might be too high for a recessionary period, and it just doesn't seem that anything is going to act—anything structural is going to act to reduce these interest rates.

And I think in that context the actions of both the financial community and the Fed yesterday are welcome. Now how many points that will milk out of the interest rates, I don't know, but there does seem to be this inherent problem that the investor still remembers inflation, and is afraid to loan his money at less than 13, 14, or 15 percent, The Federal Government is moving toward demanding 50 percent of the credit available in this country, business demand is still on the horizon when a recovery comes in—and we can have continually built into our tax code disincentives to save. That's one of my main concerns about the current tax bill before the Senate. It does nothing to increase the pool of capital available for investment, but in fact goes the other direction.

Mr. Chairman, I appreciate having that opportunity for a brief opening statement, and I'll reserve the rest of my comments for questions.

The CHAIRMAN. Thank you, Senator.

Mr. Chairman, as you well know, you received a lot of criticism over the last couple of years, and some of it from me, and particularly on the calls many, many times—virtually every time you have appeared—to do away with weekly reporting of money supply data and also to go to contemporaneous reserve accounting rather than lagged accounting.

So having done something about both problems, I think you should be publicly complimented for announcing that you are going to use contemporaneous reserve accounting and also the decision of the Fed since we last met to move to not reporting weekly adjusted money supply data.

CONGRESS BLAMED

Nevertheless, I remain convinced that it is the Congress that is primarily to blame for the failure of interest rates to decline as quickly as inflation. The first budget resolution which we recently passed calls for a steadily declining Federal deficit in the years ahead: $104 billion in 1983; $84 billion in 1984; $60 billion in 1985.

But of the $281 billion in spending cuts over the next 3 years that will be necessary to achieve these declining deficits, only $27 billion, less than 10 percent, have been reconciled or enacted into law.

My point is simply that regardless of what you do with the discount rate or changes in how you account and handle the money supply of this country, it seems to me it is still up to Congress to put up or shut up.

Is it any wonder that the financial markets have remained skeptical—as evidenced by the stickiness of interest rates—of Congress ability to make budget cuts called for in the budget resolution.

So I hope that Congress will not just pass a budget resolution then, in the individual appropriations process, not reconcile that budget. We need to send the proper signals to the market.

Mr. Chairman, recently there's been much talk of credit controls. As you know, this committee and the Congress let the authority for credit controls expire on June 30. But there has been additional talk and bills introduced in the House and Senate to not only revive credit control authority but to expand the scope of the Credit Control Act.

You were Chairman when President Carter invoked the act in the spring of 1980, requiring the Federal Reserve to impose credit controls.

Could you explain for the committee what you learned from that experience in the spring of 1980?

Mr. **Volcker**. I think one thing we learned, Mr. Chairman, is that because of psychological effects or influences that are not entirely predictable—at least they weren't predictable to us—you sometimes get results that are out of proportion to the action taken.

In early 1980, when we introduced some rather mild controls or restraints on a limited portion of consumer credit, we found, as that message was interpreted in the country, that nobody wanted to spend for a month or two, certainly not to spend on credit—to exaggerate a bit to make the point—and we had a larger impact than the action was designed to produce at that time.

I think it is illustrative of the difficulties of adopting an approach of that kind for which you don't have, by the nature of things, much experience. The effects that you get are not entirely predictable in those circumstances.

The **Chairman**. Well, I'm one who does not want to renew those credit controls. I think we have plenty of evidence—not only in the spring of 1980—that they are counterproductive. We can go back to Tricky Dicky's phase 1, 2, 3, and 4, and so on, that simply did not work. And I see no reason whatsoever to reenact the Credit Control Act.

FAILURE TO MEET TARGET GROWTH

The Federal Reserve continues to be criticized for failure to meet announced targets for growth in M_1, M_2, and M_3, and in bank credit. Obviously a major source of the problem is that you do not have direct control over these aggregates.

Why not announce targets for an aggregate over which you do have more direct controls, such as bank reserves or the monetary base? Don't you think this might increase the credibility of the Fed in the financial markets?

Mr. **Volcker**. I don't know whether it would increase or decrease the credibility, but I don't think that's an appropriate target for the Federal Reserve.

As to meeting the targets that we do have, there can be two sources, I suppose, of difficulty, if that's the right word.

One is the problem of meeting the targets themselves. Are the tools adequate to meet the target in a technical way? The other is whether conditions have changed in a way that may make it inappropriate to meet a target precisely at a particular point in time.

I would think the first half of this year had some of the characteristics, at least, of the latter situation, where demands for liquidity for precautionary balances, as we judged it, were particulary strong. As conditions developed, taking account of economic developments, taking account of interest rates and other factors, it seemed to us inappropriate—not that we couldn't have done it, but that it was inappropriate—to take a still stronger measure to restrict the growth of money and credit under the conditions that prevailed.

So I think we always have to interpret the meaning of these targets in the light of circumstances as they develop. The meaning of the target is that it sets a presumption—and a strong presumption—that you want to operate in that framework. There may be circumstances in which, taking account of all developments, it's appropriate to allow a little leeway.

I myself think the monetary base tends to be more of a lagging indicator than a leading indicator, and I don't think it would bring us better results than looking at what's happening in M_1 and the other aggregates.

The CHAIRMAN. Another criticism of monetary policy is that the aggregates that you target are too narrow and ignore major sources of credit in our economy, such as commercial paper. Why not target a broad aggregate, such as total credit?

Mr. VOLCKER. As you know, we target a number of aggregates now, and there's been some discussion recently of looking at broader forms of credit aggregates than we include formally.

I think targets are relevant economic variables, and we do and should look at them. We have not been convinced that as a formal targeting mechanism they offer a substantial improvement, but we continue to look at that issue, and I haven't got any preconceived notions on that score. We haven't seen that that would add much. But I think it's relevant as a magnitude to look at and to observe in connection with the other targets.

One difficulty with credit—a technical point—is that some of that data is not as up-to-date as looking at the other side of the balance sheet which is essentially what we do in looking at the monetary targets.

The CHAIRMAN. Episodes such as the recent Drysdale Government securities problem and the failure of the Penn Square National Bank in Oklahoma cause the Fed to inject liquidity into the economy through the discount window.

What impact does this have on your ability to implement monetary policy and you completely offset the discount window loans through sales of securities in the open market?

Mr. VOLCKER. The first point I would make is that those incidents have not required any substantial injection of liquidity through the discount window. If they had, in connection with the fundamental role of the central bank as lender of last resort—lending to those that are caught up in the secondary repercussions of an incident of that sort—if that became necessary, the first assumption, I suppose, would be that that would be offset by sales of securities from the portfolio so that it does not necessarily mean that we would deviate from reserve objectives or from monetary objectives.

You could conceive of situations in which you might want to provide some additional liquidity to the economy as a whole, and then you would handle it somewhat differently. But increased use of the discount window in reaction to that kind of event has not been at all significant. If it were significant, it could be offset by open market sales.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator Riegle.

Senator RIEGLE. Chairman Volcker, I want to try to set the stage here for some responses from you by making some observations as quickly as I can. At the outset I recounted several measures of the damage that's been done to the economy in terms of the high unemployment, the shutdown of the economy, the tremendous damage that's been done to any number of interest-rate sensitive sectors of the economy.

I believe that we have a desperate situation on our hands. That's confirmed by conversations that I've had the last 4 or 5 weeks with the heads of most of the major banks and financial institutions, and a number of large corporations in this country.

NEED FOR MAJOR CHANGE IN POLICY MIX

They all to a person feel that the economy is in desperately serious trouble and there is requirement for a major change in the policy mix. At the same time there's really no sign that change in the policy mix is coming any time soon or that the key decision centers—the President and perhaps at the Fed as well—have a sense that a change is needed.

I can tell you as a member of the Senate Budget Committee that my own estimates for the deficit—if we stay with the current fiscal plan—will be in excess of $130 billion for next year, in the range of $200 billion for 1984, and a range of $300 billion for 1985.

I don't see how our economy can function if we stay on that path. As a matter of fact from everything I can see, the President, who is the most important player in this discussion, is at peace with these deficits—as a matter of fact, he came in with a budget that asked for even higher deficits.

I think the high interest rates that we have now are just ripping the guts out of this economy, and you can see it everywhere you look: From the financial institutions across to the housing sector into the industrial base, into agriculture. There really is no part of the economy that has not now been affected and damaged—and I think in many cases permanently—by this high interest rate policy.

So there is a need—a desperate need—for a change in the policy mix, and yet there's no sign of any change in sight.

Now the Congress, according to Senator Baker, is targeting to adjourn on October 2. We have about 45 working days left here, if one takes out the weekends and the planned recesses.

The window is closing on this session of Congress. Once the Congress shuts down, we're not going to be back into the new Congress until late in January. You take out the Lincoln day recess in February, and it's going to be the beginning of the second quarter of next year before the Congress will be in a position to act in a major way, if we miss the opportunity to make a major change in the economic policy mix at this time.

And I'm greatly concerned that we're missing that opportunity; I'm concerned the administration is missing it, I think the Congress is missing it, and it appears to be the Fed as well is missing it.

The lowering of the discount rate yesterday I think shows a small shift in your own policy, but it is a very small change and it comes very late in the game, and there's no way of really measuring whether or not this will have any appreciable effect on this larger set of problems.

I think you ought to be more outspoken in your appeals publicly and your appeals privately to the President, in your appeals to the Congress and within the business community.

It's possible from your vantage point that you can have as much to do with helping to create a sense of urgency about a need now for a change in the policy mix as anybody.

And I believe if it doesn't happen, you're going to find yourself, and the Fed is going to find itself, more and more compelled to have to act unilaterally. Because if we see more bank failures, we will see more panic, we will see more people moving into more liquid assets and into short-term Government securities. I've talked with heads of major investment companies in the United States who are changing their own personal financial plans because of their apprehension about the future of the economy.

The thing that worries me now is that we may find ourselves in period when we're not going to be able to act readily as a Federal Government to change policy because of the shutdown that occurs as we come into an election year of this kind.

And I think that we can find ourselves at some point facing some kind of panic—some kind of financial panic—and possibly even a genuine fear that a depression could develop.

We have Canada in shambles on our northern border; we've got Mexico in shambles on our southern border; we've got nonperforming loans by major banks all around the world and across the United States.

And my question to you is that if this comes, if we miss this very small opportunity that's left for a major change in the policy mix—and I'm talking about a substantial reduction in deficits and a substantial change in monetary policy and a big reduction in interest rates that would come within a matter of weeks—if we fail to get that done collectively, are you prepared to act unilaterally at the Fed, should we find ourselves in a kind of growing panic situation.

Will you move then? Will you either increase the monetary targets or will you bring down the discount rate further, if in fact you find yourself alone out there with the situation worsening and the

President not connected to the problem and the Congress not even in session?

Mr. VOLCKER. I'll make a couple of comments on your comments, Senator.

I yield to no one in my concern about the budget, and I think that I've made that plain through the months. I'm not quite as pessimistic as the figures that you cited for the out-years on the budget.

I do think that we collectively, in a sense, missed a great opportunity this spring to more forcefully and dramatically, through some process of consensus, take more forceful action on those out-years. As you point out, there is relatively little time left in this congressional session, and you've got your work cut out for you in implementing the budget resolution that was passed. I very much look forward to your coming back for the further large bites that I think are necessary in the budgetary situation—after November.

But I try to be realistic, and I don't know if there's anything hugely dramatic, beyond what is incorporated in that budget resolution, that can be done within the next month or two.

I recognize your concerns about the economy and about the financial system, but let me say that I don't share those, to the extent that you have cited them.

I think that we are clearly in a difficult period. We are still facing the damages, as you put it. In my mind, they are the damages of handling the long episode of inflation and turning that around. But I think that we are laying a strong foundation for the economy. If some of these contingencies of which you speak arose—I don't believe they are going to arise—I think we can be sure the Federal Reserve is well aware of its responsibilities as lender of last resort and provider of liquidity to the economy.

Senator RIEGLE. How much effect do you think the lowering of the discount rate, of half a point yesterday, is going to have? And over what time period?

Mr. VOLCKER. I wouldn't isolate that particular move.

Senator RIEGLE. Let me try and isolate it. I realize that there are a lot of other factors—but just that particular move—what do you think it, by itself, might accomplish? Obviously you decided to take it for a reason.

Mr. VOLCKER. We took it in the light of rather sharp reductions in short-term interest rates that had already taken place in the market; so, to some extent, you can consider that a move of alinement to changes that had already taken place.

You can ask why the other changes took place. We had the money supply in pretty good control. Banks have been under less reserve pressure in recent weeks. The economy appears to be in a fairly level phase. There are a variety of factors. I think the budgetary progress, limited as it is, helps, relative to the situation of not having had that progress. A variety of factors have entered in, and the discount rate change is one part of that complex.

I think that it does tend to anchor the reduction in short-term rates that took place.

FLIGHT OF MONEY TO SHORT-TERM SECURITIES

Senator **RIEGLE**. Do you see any movement out of people holding long-term securities and short-term securities? Do you see a flight of money into shorter and shorter term securities?

Mr. **VOLCKER**. I think for some months, as my statement suggests, we have seen evidence of a desire for liquidity; and that is part of that phenomenon.

Senator **RIEGLE**. What does that mean? What do you interpret that to mean, the fact that there is this rush toward liquidity?

Mr. **VOLCKER**. I think it means several things.

This is partly in the realm of speculation. We have a variety of evidence, survey evidence and other kinds of evidence. It is not atypical during a recession to have a desire for more liquidity.

This time, more than in some past recessions, some of it may reflect uncertainty about interest rates themselves. Of course, we have had a high level of short-term interest rates, so it's been attractive, just on sheer financial grounds, so to speak, to park money in liquid assets.

Senator **RIEGLE**. If we don't get long-term rates down, if we don't see some willingness of people to finance long-term investments—whether it's for houses, factories, or whatever it might be—how are we actually going to get an economic recovery going?

If everybody is moving in the direction of short-term instruments, then how could we possibly get things moving again?

Mr. **VOLCKER**. I think it's possible to do so. As I indicated, I think the recovery in the near term is going to be fed largely by consumer spending, which isn't so dependent upon long-term borrowing—probably not dependent upon long-term borrowing at all.

I fully agree with you. We would be in a much better position, much happier position, if long-term rates were lower. When you emphasize long-term rates, I think that it is, in a sense, illustrative of the policy problem; this is, we can't control long-term rates and they're going to depend upon the decisions of those in the marketplace and their having enough confidence to go out and buy longer term securities. That is one reason why I think that it's so terribly important, if we're interested in getting interest rates down—and particularly long-term rates down—that we carry through on dealing with inflation. That's the thing that will really spook the market in terms of making an investment for the long term. The investor is making a bet for 10, 20, or 30 years, depending on the security; he's going to be looking at the chances for stability—or for greater stability—than we have had over that length of time in recent years.

Senator **RIEGLE**. My time is up. I will have more to say later. But it seems to me that we have not made much progress on that front.

Mr. **VOLCKER**. We have not so far, I agree.

The **CHAIRMAN**. Senator Tower.

Senator **TOWER**. Thank you, Mr. Chairman.

Chairman Volcker, I want to congratulate you on having the courage to do what you perceive to be right, rather than what may be politically popular. And although I may be inclined to disagree with you from time to time myself, I hope that we will never be in a position where we feel tempted to threaten the independence of the Federal Reserve Board.

I think it's been the only agency of Government that has, regardless of political fallout, proceeded to do what it felt to be necessary.

I can't help but be reminded that you and I are both products of the London School of Economics. I rather fancy, every time you make a pronouncement on fiscal or monetary policy, that Lord Keynes and Harold Lasky start turning in their graves.

Mr. Chairman, many analysts suggest that we have, in effect, two credit markets, that interest rates are affected by different factors. For example, they suggest that the long-term rates are staying high because of expectations of future inflation, very large deficits, or both; while short-term rates are high because of supply and demand forces—that is to say, business and Treasury loan demand is greater than the supply of credit.

Do you agree with that analysis?

Mr. VOLCKER. I certainly agree that you would expect long-term rates to be affected more by the expectational factors, and short-term rates probably more immediately by the quantitative magnitudes involved as opposed to the psychology, although the distinction is not a clean one.

EFFECT OF UNREGULATED MONEY MARKET FUNDS

Senator TOWER. Mr. Chairman, to what extent to you believe that the availability of unregulated money market funds contributes to the continuation of high interest rates?

Mr. VOLCKER. I would not, I think, put a lot of importance on unregulated money market funds in and of themselves.

I do think that the move toward deregulation in the financial world generally, including banks—and the money market funds are one manifestation of that—means that the restraint that used to come out in a rationing of credit in the market now comes out virtually entirely in interest rates. That has probably meant a higher level of interest rates in these past few years than you would have had with the different institutional arrangements that we had in the 1950's and the 1960's and the early 1970's.

To put it badly, now when money is restrained, banks don't stop making loans, they just raise the rates until the borrowers are squeezed out.

In the good old days—if they were good old days; people didn't like them much when they existed—when there tended to be pressure on the money market, the banks and financial institutions were, to some extent, rationed out themselves; interest rates would push up against the ceiling rates, and they would slow down in making loans. They raised interest rates, too, but not as far, because some of the restraint came through by way of a rationing process rather than from interest rates alone.

I think this whole thrust—of which money markets are merely one part—has resulted in a type of money market in which interest rates are more volatile and higher, at least during the restrictive phase of policy, than they otherwise would be.

Senator TOWER. This morning, in the Washington Post, Allen Sinai suggests that the lowering of the discount rate will be of no help before the fourth quarter. He says, in effect, that this quarter is already lost.

Do you agree with him? And specifically, what result were you hoping to achieve as a result of this action?

Mr. **Volcker**. I don't agree that the third quarter is lost, for whatever reason. We're trying to conduct a policy which continues the progress on inflation, but also leaves room for recovery. We have no desire to have interest rates any higher than they need be. As I indicated, I think that the discount rate move was a reflection, to a considerable extent, of declines in market rates that had already occurred, and has the effect of anchoring those for the time being to some degree.

Senator **Tower**. Mr. Chairman, we are due to mark up a bill in the near future that, among other things, is designed to give some assistance to the thrift industry.

In your view, will providing thrift institutions with banklike asset powers enable them to solve their problems before it's too late for a number of individual institutions?

Mr. **Volcker**. I don't think that providing new powers—more particularly, commercial loan powers—at this point in time is going to have much relevance to their near-term problems. I think that has to be viewed in the context of the direction that you would like that industry to go in over a period of time.

I don't see it as any saving measure for the immediate future, in terms of the present squeeze. In fact, there are some dangers in going into a new business rapidly, in the hopes of increasing income; you've had some examples recently of banks being a little overambitious in that area and getting into trouble.

Senator **Tower**. Are you saying, then, that nothing can be done to alleviate the immediate problem?

Mr. **Volcker**. No. I simply was referring to that particular portion of the bill. The legislation you are considering has measures in it that are directly relevant to the immediate problem. In the capital infusion area and the so-called "Regulators Bill" the considerations are very directly relevant and important for the current problems in the thrift industry. I think they are very important, given the current problems that we have in that area.

Senator **Tower**. Are you worried about the safety of the financial industry right now?

Mr. **Volcker**. No. I think that the financial system in this country is a strong one. As I indicated in my statement, we have an elaborate system, with the Federal Reserve, the FDIC, and so on designed to backstop that system. I am not concerned about the system in general.

There are obviously points of particular strain, in that financial institutions are feeling the effects of the recession, in some cases. We have been through periods of this sort before—most recently, in the mid-1970's—but I think that the system has great resiliency and strength, and great support when and if it's necessary, from the governmental institutions.

Senator **Tower**. Thank you, Mr. Chairman. My time is up now.

The **Chairman**. My policy has normally been to recognize Senators on the basis of when they came in, rather than seniority. But we have had enough come in and go out that I'm not quite sure who came in when. So, unless there are some objections from the committee, I will simply stick to the seniority system and go to Senator Proxmire. But if anyone remembers when they came in and ahead of whom, we can go back to the normal practice.

Senator **Proxmire**. Mr. Chairman, I certainly would not object. [Laughter.]

Chairman Volcker, as you know, I have been an enthusiastic supporter of yours and your policies—and I still am. And I do think, as others have indicated, that the problem is that we have had an irresponsible fiscal policy that has gotten out of control. And you have a very, very painful and difficult job.

On the other hand, I think that we ought to recognize that, when you started this new policy in October 1979, of concentrating on money supply, a prime purpose of that was to get inflation under control. And I think with all the other problems in the economy—and they are great—the inflation picture has improved, and has improved sharply.

Last month was an abberration, but over the last 6 months, there is no question that inflation is much better than it was. As you know, that big philosopher, George Santana, used to say "fanaticism is redoubling your efforts when you've lost sight of your objective."

I think that maybe the Federal Reserve Board is a little guilty of that kind of Santana-defined fanaticism.

Here, as I say, inflation is under control. You are not adjusting—as I understand it, you are not adjusting your money supply targets' ranges; they are still very conservative. And when we consider what causes inflation—inflation, as I understand it, and most of us agree, is caused when demand puts pressure on limited production facilities.

Now we have a situation where, in our big industries, our credit-sensitive industries, we are operating far, far below capacity. There is enormous surplus manpower. It seems to me that the latest report, only a week or so ago, indicated that for the first time in years we are operating below 70 percent of capacity; the automobile industry, below 50 percent of capacity; the homebuilding industry, even lower than that.

And if we do increase the availability of credit, it would seem to me that there is no way that that would be inflationary, even if the increase in availability of credit were quite substantial.

So, how would you address that general notion, that inflation has improved greatly and it is time that we do ease up, to some extent, on the availability of credit in a credit-starved economy?

TURNED THE CORNER ON INFLATION

Mr. **Volcker**. I do think we have turned the corner on inflation, but I don't think the problem is over. Of course, I would not agree that we have lost sight of our objectives at all. Let me review the targets.

In particular, based upon all recent historical experience, it is our judgment that the targets as they are—and note that I have said we find it quite acceptable to come in around the high end of those targets—should allow room and be fully consistent with the kind of recovery that most economists have been predicting in the second half of this year.

That does assume that velocity will be more or less normal; it doesn't have to be particularly on the high side for a period of business recovery.

What evidence do we have, other than looking at the historical record, in making that kind of a judgment? I have noted that we do think there are some potentially and actually unusual characteristics that may require some more liquidity and have required more liquidity in the first half of the year than an absolutely literal interpretation of some of the targets indicated. If we found that to be the case in the second half of the year, and there was clear evidence of that, I have indicated we would be willing to run above the targets for a period of time.

But now we come to the other side of the dilemma. I agree with you that, as I indicated, a lot of progress has been made on inflation. I agree with you that considering economic conditions, there is every reason to believe that that progress on inflation can continue during a period of business recovery, certainly as far ahead as we want to look now.

That's all on the favorable side. But in connection with the discussion with Senator Riegle earlier, look at long-term rates, for instance. To the extent that they are important and a key to sustaining recovery, I don't think we are going to do ourselves or anybody else a favor with respect to long-term rates if we convey the impression or the actuality that we were no longer worried about inflation. I think it would be counterproductive in terms of impact precisely on those interest rates that are so significant to business and the housing area.

Senator **Proxmire**. I certainly wouldn't argue that you ought to forget about inflation. It's certainly a serious and potential problem. But the difficulty is our deficits are so colossal, the Federal Government is borrowing so much—you know the figures—the early 1970's the Federal Government took $1 out of $6 of new credit, last year took $2 in new credit, next year it will take close to $3 out of $6 in new credits, crowding the industries like automobiles and homebuilding and so forth, so that they just don't have credit available without paying very, very high rates.

It seems to me the realistic way to meet that would be to find some way of making more credit available one way or the other. Senator Lugar had one kind of proposal for the housing industry. I supported that, and I think you opposed it, as did the administration. It may have been defective, but some way, it seems to me, we have to work out an economic system to put our people to work when obviously that idleness accomplishes nothing. It hurts our growth, our efficiency, and we just have to find some way to overcome that. And part of it is high interest rates.

Mr. **Volcker**. I think you put your finger on the problem. You identified the Federal budget as being part of the problem and, in effect, seem to be asking if you can cure that through monetary policy. We can't cure the Federal budget through monetary policy. Now, it's a matter of judgment as to what is excessive money growth; I fully agree that issue should and can be debated. But we can't cure the basic problem resulting from the percentage of the credit market availabilities absorbed by the Federal budget by creating an excessive amount of money and credit in total, because then we would come back to the inflation side of the dilemma. That would have an adverse impact on interest rates, rather than a favorable impact on interest rates.

IDEAS TO CHANGE BUDGET PROCESS

Senator **Proxmire**. Let me ask you for some advice that you can give us, then. Other Chairmen of the Federal Reserve haven't been reluctant to give us that kind of advice. In fact, as long as I can remember, every Fed Chairman has indicated to this committee that the Fed can't fight inflation alone. Federal spending must be constrained. We now have facing us the largest deficits in our history. The budget process has not convinced anyone that interest rates can decline. In fact, some observers have said the budget process doesn't work; it needs reform; we need an amendment to the Constitution.

If you could change the budget process, what would you do? Would you put a cap on Federal spending? Would you make the budget a multiyear process, require a two-thirds vote on budget resolutions? How would you restrain them?

Mr. **Volcker**. I can give you some tentative ideas on that, anyway. As I observe the budget process in recent years, I think there is something to be said for making it a multiyear process—making it, let's say, a 2-year time perspective. It appears that you are continuously in the budget process now, and I wonder whether it wouldn't be better to try to set out a framework for a couple of years instead of for 1 year. You might get a better result.

As far as other changes are concerned, I have been hesitant, to say the least, about the particular structure of the balanced budget amendment that's being considered by the Congress.

Senator **Proxmire**. You favor that or oppose it?

Mr. **Volcker**. I have great sympathy for its objectives, but I have considerable difficulty with the particular form of the amendment.

Senator **Proxmire**. If you were a Senator, would you vote for it?

Mr. **Volcker**. If I had my druthers—and I was about to suggest this—I think there is a bias in the system toward deficits and toward more spending than the collective will would really suggest is appropriate; it may not be a bad idea therefore to require, as you were suggesting, more than a majority vote for spending of any sort, whether or not it depended upon a particular phase of the budget at a particular time. This is a very sensitive area. I think you could probably improve the budgetary process if the President had an item veto.

Senator **Proxmire**. You don't want to answer the question as to whether you oppose a balanced budget?

Mr. **Volcker**. If I could vote on one of the other proposals, I would prefer to.

Senator **Proxmire**. Do you think we should support a constitutional amendment balancing the budget or not, requiring by amendment of the Constitution?

Mr. **Volcker**. I would like to move toward balancing the budget, but I am not sure I would support that particular amendment.

Senator **Proxmire**. I will mark you down as not exactly sure.

Mr. **Volcker**. As I said at one point, I am for it with reservations, and maybe against it with reservations. I applaud the spirit that's behind it, but I do have some reservations about that particular mechanism.

Senator **Proxmire**. Would you agree with Senator Riegle that you are leaning no?

Mr. **Volcker**. I think that's probably accurate in this. [Laughter.]

Senator **Proxmire**. My time is up.

The **Chairman**. Senator Lugar.

Senator **Lugar**. Chairman Volcker, in the past you have explored the problem of inflation, and among other points you have made is that it's very difficult to break through various flaws, rigidities in our economy; that inflation may be a process in which various groups have the power to enforce prices and to enforce wage levels, and as a matter of fact, as we have noted even recently, some things that have been going well in inflation—the regrouping of OPEC, at least temporarily. We had a spurt in the inflationary side on the energy, based on 1 month.

In short, even though the policy of Fed, maybe of the whole Federal Government, has been to break the back of inflation, to what extent are these rigidities that were a part of the picture 1 year, 2, or 3 years ago still there and to what extent can we have any confidence that we are not likely to have very substantial inflation due to the fact that people want to maintain their claims and are able to do so politically?

Mr. **Volcker**. I think you put your finger on the heart of the problem. We have one tool of policy which works in a rather crude kind of way against those rigidities and claims of which you speak. I think there has been some success, but the cost is much higher than is necessary because of those rigidities and claims.

I would hope that out of this experience and the fact that those who are in a most exposed position are not always the ones who are hurt most immediately, we will find a different climate and a more satisfactory situation in that respect. But it's been a very long-term problem. It's the kind of problem which is addressed by so-called incomes policies.

The way we have gone about that in the past in this country has not been terribly successful, probably damaging on balance. That's generally been my view of the experience in other countries.

At the same time, there is a lot of hard experience that is potentially relevant to us. There are some countries that do this job better, reflecting a kind of social consensus, I suppose, as well as some institutional arrangements that don't exist in this country. Whether it's a process of annual wage bargaining across the board, where all the parties take some account of how their particular claims fit into the national need; whether it's a different climate within particular countries as to labor-management relationships, with implicit contracts with respect to employment as well as wages; I think all of those things are relevant, and I would hope we could learn from some of that foreign experience over a period of time. But that's a long-range matter.

LARGE LASTING DEFICITS

Senator LUGAR. Let me ask a question that calls for general counsel. I am disturbed by the fact that I think many of the rigidities are still there, and you may feel they may still be there, too. We try to influence things so they become more fluid, but what if we have a situation in which we still have very strong collective bargaining arrangements, pricing policies, that may not have realism with regard to actual markets for goods and services, and I wonder if, coupled with this, we have a situation of deficits that we discuss today and we all condemn these, and really part of the problem is congressional inability to stop the spending. The greater part is simply that the economy is working so poorly, that the revenues coming in mean that if we're going to have very large deficits for a long time, largely because people do not make enough money as individuals or as corporations, the whole tax base is simply insufficient. So given even minimum requirements of social security and defense situation and the Government, even at a minimum we have continued to have very, very large deficits because the economy just didn't work.

For example, if automobiles are still in a decline, the housing situation is more of a disaster this month, steel clearly is still headed down, agricultural implements already down and getting worse, farm income not very promising except in the livestock area, clearly not in the grain side; there are just no signals on the horizon that look toward greater income, and this probably means greater deficits, not because people were irresponsible, necessarily, in economy—just because the economy doesn't work.

Now, on the one hand you would point out we can't give up the inflation fight, and I would agree with that, but I wonder if companies and labor unions and various groups in our society are just totally unresponsive to the reality of what we face, and as a result, continue to accept more and more unemployment and economic disaster lamenting the political situation, while in fact the signals just don't get out.

Mr. VOLCKER. If that were literally true, we'd have an impossible problem. I think your statement is too extreme. I share your very great concern about these rigidities and claims. But obviously, people do respond, and we are seeing perhaps a greater response than might have been expected. I think that is one reason why it is important that we remain in a posture of concern about inflation, because nobody is going to give up those claims if they think things are going to be aggravated by inflation and that Government policy is going to yield in those respects. I wouldn't be quite as pessimistic as you are in that respect, or at least as your statement was.

As far as the budget is concerned, I think you have a difficult enough problem in substance, but in communicating and in analyzing the situation, as I've indicated in my statement, I would discount very heavily that portion of the deficit which arises purely from poor economic performance. You're quite right, obviously; the economy isn't expanding. You're not going to get the revenues normal in an expanding economy, and when you analyze the budget situation at any particular point in time, I think you've got to take account of that, but the deficit simply doesn't mean the same thing if it is generated out of poor economic performance as it does if it appears in a growing, rising economy.

I think the budgetary resolution, the budgetary deliberations, attempted to handle that problem, more or less correctly, by assuming we were going to have a satisfactory period of economic growth during a time the budget was rising, then looking at the deficit as it would be in a satisfactory economic environment. I think that is the appropriate way to approach the deficit problem.

My only problem, looking at the deficit in that light, is that, even if everything went just right, according to the budget resolution—and Congress did everything it needs to, and those estimates were right, and those administrative actions indicated in the budgetary resolution actually produced every dollar that they were assumed to produce—you would still end up with as big a deficit next year as you have this year, assuming that you don't have the complication that you referred to.

Senator LUGAR. Doesn't that imply that the successful game plan all along would have to have been one of dynamic growth? There was no way for us to pay our bills without very substantial economic growth in the country, and that there is nothing at least that I can see in that whole budgetary picture, nor in the monetary policy of the Fed, that is likely to cause that degree of investment activity to leap forward. In other words, we're all assuming that this is a natural consequence. What goes down must come up; but why? Is there anything out there right now that leads one to believe that investments are going to be made as opposed to money parked at high interest rates?

RECOVERY PREDICTED

Mr. VOLCKER. When you speak of leaping forward, I don't know what quantitative magnitudes you have in mind. I don't think it's a process of leaping forward, but certainly it is one of progressing. I think there are a lot of things out there that can produce an economic recovery. Business investment is not one of those in the period immediately ahead; I think business investment is weak and the economy is going to rise in the next few quarters, in my opinion, because consumption will be increasing, defense spending will be increasing, defense ordering will be increasing, and because we have had a very substantial inventory liquidation.

Inventories are notoriously difficult to pick in terms of timing and magnitude, but it seems to me we should not expect to have inventory liquidation at the rate of speed that has been occurring for much longer. That turnaround in the inventory picture alone can support an advance in economic activity for some period of time.

What we would hope would happen, of course, is that as we get into 1983, the business investment picture begins to turn around, and the housing picture turns around so we have continuing support for economic expansion from those very important sectors of the economy. It's better than nothing, but we don't want to have an expansion that's resting on consumption, or even inventory behavior, indefinitely. That's not a very healthy kind of expansion.

Senator LUGAR. You are confident that, if not automatic factors, at least substantial factors are likely to lead to consumers buying, the inventory situation turning around. Do you think this is a sufficient enough phenomenon that it cures itself without direct political action or some economic plan?

Mr. VOLCKER. Yes, I think that is the prospect. That doesn't mean a very strong recovery in its early stages. It means a somewhat unbalanced recovery in its early stages. But there are indications of rising consumption; there were indications in the second quarter; the June figure was not good, but the April and May figures showed sizable increases.

Of course, we had a tax cut effective on July 1. We have a large Government deficit that is pumping out purchasing power. I think there is hard analysis that suggests there is reason to expect forward movement on the economy.

Senator LUGAR. Thank you.

The CHAIRMAN. Senator Cranston.

CONSTITUTIONAL AMENDMENT

Senator CRANSTON. Mr. Chairman, could you spell out your concerns about the form of the constitutional amendment that is pending on balancing the budget?

Mr. VOLCKER. I testified on this some months ago and looked very carefully at the Senate report and other discussions. As I said, I very much sympathize with the objective, but you asked me about the form. There, questions arise as to what happens when you have a situation where, let's say, there is an indication of lack of balance in the budget and you can't get a 60-percent vote to pass the unbalanced budget, because you have an impasse among those who say "What do you do about it?"

In the analysis of the amendment that I saw it was quite clear that it wasn't the intent of the authors to give the President any additional power to do anything about that. There was discussion about whether the Supreme Court would then step in and demand action, and it was quite clear in the report that the authors of the amendment didn't think that was a very good idea. The Supreme Court shouldn't get into this thorny, political area. It was left, essentially, as I read it—overstating it a bit—that the forces of public opinion would require that the Congress somehow reconcile the discrepancy.

How successfully would that process work out in a situation in which—and this is conceivable, anyway—you have strongly held views on both sides of the issue in a narrowly divided Congress? Would you go for a 60-percent vote and have an unbalanced budget? How would you collect a majority to cut back particular areas? There seem to me difficulties of such a process.

There were also questions, which I have no particular expertise on, as to how the spending could be accomplished through the back door or pushed off on the States and local governments.

The objective is admirable. My question is whether there are not better ways to achieve the objective.

Senator CRANSTON. There is a substantial question about whether or not the courts would not be drawn into the budget process in ways that would threaten the separation of powers. There is a widespread feeling, I believe, that there would be ways to get around the amendment, that ingenious accounting suggestions could be provided and that therefore it could be rather meaningless, could raise false hopes, and would therefore rather demean the Constitution processes.

Mr. **Volcker**. Let me say—I am repeating myself, and I apologize—that if you accept the basic analysis which was put very decisively in that Senate report—that there are institutional and political factors in today's world that push you into more unbalanced budgets than anybody would think is desirable—then I think there is something to be said about changing the constitutional processes to counter that bias that seems to exist. It is a question of how to do it.

Senator **Cranston**. It certainly is a question about how to do it. There are faults in the proposed amendment that could be corrected. Whether or not they can be on the Senate floor I do not know.

One of my concerns about enshrining a mandate for a balanced budget in the Constitution is the relationship between outlays, receipts, and economic assumptions, including monetary policy, aggregates and ranges of growth, which go into attempting to put together a balanced budget. In my view, one of the prime factors in the gross underestimating of the magnitude of deficits by this administration, by prior administrations, lies in the original assumptions about monetary policies used by OMB which turned out to be far removed from reality.

So, I would like your comments on the relationship of monetary policy assumptions to the so-called unexpected deficits that appear year after year in the budget. Do you feel, in other words, that an inability to predict what the monetary policy was going to be was one of the factors that led to an inability to project what the budget was going to turn out to be and what the deficit would be accurately?

Mr. **Volcker**. You can make a very general statement that there are difficulties in economic forecasting, whether it's about monetary policy or anything else, that are going to affect the particular numbers in the budget as they emerge. I don't think there is any bias. I am not aware of any reason why there should be in predicting monetary policy explicitly that would lead to a bias in the budgetary results in one direction or another over a period of time.

One of the difficulties, of course, always in the budgetary process is projecting the economic environment that will exist. As Senator Lugar was emphasizing, the revenue outcome obviously, and to a lesser extent the expenditure outcome, depends on the level of economic activity. That can work in either direction.

The budgetary problem that an amendment ought to be aimed at is that in good years, bad years, indifferent years the bias toward deficits seems to exist. I might say, I don't see it as the purpose of an amendment to enshrine a particular economic theory in the Constitution, but rather to deal with what seems to be a kind of political bias that operates in an environment—with whatever particular theory you are operating under at the time.

Senator **Cranston**. That may be part of the purpose, but the actual effect of the proposed amendment in its present form is to fix one economic theory in the Constitution, the theory that a balanced budget is advisable under all circumstances and a provision limiting the growth of Government in a very severe way by tying it to national income without defining what national income is.

Mr. VOLCKER. That is why, I suppose, in a kind of conceptual way, that bias probably exists in good years, bad years, whether the budget happens to be balanced in some particular year or not.

If you have got a chronic problem of too easy spending, in some sense, then deal with that directly rather than only in years when you have an unbalanced budget.

Senator CRANSTON. In relationship to the question I was asking you about, projecting what is going to happen, would you see any problem in requiring the President and the Congress, both to propose a statement of outlays and receipts through a constitutional amendment in order to come up with one that is in balance, would you see any problem in requiring the President to state the monetary policy which is assumed to underpin the balanced budget statement just so you have some idea of what to expect and upon what the balanced budget was based in terms of monetary policy?

Mr. VOLCKER. I think I am skeptical of enshrining that kind of thought in law, let alone in the Constitution. You have got a problem, a kind of threshold problem, of how you measure monetary policy; we struggle with that all the time.

But what is the meaning of these particular monetary aggregates over time? That is a very definite question when you are in a world of shifting technology and a shifting financial environment. Even in a particular period of time as this year, I think we have to evaluate the meaning of growth in any particular aggregate, or all of them together, in the light of changed circumstances during the year, and I don't know how you would reduce that to a statistic at the beginning of the year.

We do it as carefully as we can, of course, in setting these targets; but if everybody were, in effect, putting forward a different number, you would have even more problems, I suspect, in making intelligent judgments during the year.

Senator CRANSTON. Your response would seem to underscore the great difficulty, at the beginning of a year or even before a year is begun, to predict what is going to happen to the economy and what the effects of that will be on the budget.

Mr. VOLCKER. I agree with that.

Senator CRANSTON. You have met in recent days with Mr. Meese and Mr. Baker and other people in the White House. Did their views on the state of the economy and what monetary policy should be have any impact on the decision made now to reduce the discount rate?

Mr. VOLCKER. No, I don't think that decision was affected by any conversations that I have had with members of the administration. I have continuing conversations with members of the administration whether or not we are changing the discount rate.

Senator CRANSTON. Are you at liberty to tell us anything about the views that they have been expressing concern about Fed policy, its impact on the economy?

Mr. VOLCKER. I think it is no great secret to say that they, like everyone else, share concern about the economy, interest rates, and the whole surrounding set of issues.

Senator CRANSTON. Well, they are naturally concerned, but are they specifically concerned about the effect of Fed policy, as presently pursued, on interest rates and, hence, on the economy?

Mr. VOLCKER. I don't know exactly what you have in mind, but in terms of particular criticisms or very specific suggestions, no.

Senator CRANSTON. They have not made any suggestions for any particular changes in the Fed policies?

Mr. VOLCKER. No.

IMPACT OF GOVERNMENT BORROWING

Senator CRANSTON. Can I ask one more question? My time is up. What do you think will be the impact on interest rates when the Government proceeds to borrow some $50 billion or a somewhat similar sum because of the size of the impending deficit?

Mr. VOLCKER. If you borrow $50 billion, or whatever the figure, in the next few months, interest rates will be higher than they otherwise would be. But I would be hopeful that we can get through this period with declining rates. If anything, interest rates are extraordinarily high to start with.

The economy is soft. Private credit demands could well decline during this period, and they have not been particularly high. There have been a lot of credit demands on the banking system, and they are very visible; there is a certain amount of pressure in the banking system because so much of the business credit demands are short term and focused on the banking system. But, fortunately, private credit demands in total are not so high at the moment, for obvious reasons; the economy is soft.

I don't think that Treasury financing job, large as it is, in the near term presents an insuperable obstacle to lower interest rates during this period, but it sure doesn't help.

Senator CRANSTON. Thank you very much.

The CHAIRMAN. Senator Brady.

Senator BRADY. Chairman Volcker, I would like to go back to Senator Lugar's line of questioning, which was generally aimed, I think, at how does the economy start going again. I have a concern that we are in kind of a gridlock with respect to interest rates, where we have all sorts of intersecting forces that sort of met at a corner, and I don't quite see how we are going to get out of it.

HUGE SHORT-TERM BORROWING

One new phenomenon, and I would like to get your feeling on it, is that after the 1974 recession the additions to short-term credit were limited. I think in 1975 and 1976 the flow of funds charts would indicate that there wasn't a great deal of short-term borrowing. Now we are in a recession in 1981 and 1982, and you have almost the reverse phenomenon, which is huge borrowing in short-term markets.

I am sure you have thought about this, and I wondered whether you have any feeling as to what would alleviate that new phenomenon. Why does the phenomenon exist now when it didn't exist in 1974?

Mr. VOLCKER. I think there has been some tendency for borrowing to take place either to maintain or improve liquidity positions in a period when profits obviously have been reduced. The complicating factor is that businesses generally have had a trend toward depleted liquidity positions, not just in the last 6 months, but in the last 20 years, quite literally, and all during the 1970's.

They went into this recession with liquidity positions affected entirely apart from this recession, liquidity positions that were already well depleted, balance sheets that were strained relative to earlier periods, with less equity, more short-term debts. Then they get squeezed by the recession and they have to maintain liquidity. There is a lot of concern about liquidity positions, and so, I expect, some anticipatory borrowing.

There are some indications that the corporate sector as a whole is showing increased liquidity. If the economy turns around, and as the economy turns around, you ought to get some increased cash flow from profits. And, as confidence returns, you could see less demand for business credit for a time and, perhaps particularly, demand less concentrated on the short-term market to the extent the long-term markets open up at all.

You used the figure of speech gridlock, and I think that is appropriate in some respects, because demand is concentrated in the short-term market, as the long-term market has not been very inviting. Short-term rates have remained high, and that helps to keep the long-term rates up; and with long-term rates up, people borrow short, which tends to keep the short-term rates up.

But gridlocks can be broken; this is taking longer than most people expected, but the favorable factor in the outlook is, indeed, that inflation is coming down. I think inflationary expectations are changing, and that, in a fundamental way, sooner or later, is going to contribute to breaking that gridlock.

Senator BRADY. If you had to guess where the gridlock might be broken, where would you think it was going to be?

Mr. VOLCKER. I am not going to guess precisely. Maybe we see something of that happening now, but I don't want to make a precise forecast.

Senator BRADY. With regard to the two markets that Senator Tower was referring to, the short-term market and long-term market, to what degree is the Fed's ability to help—and be imaginative—blocked off by the fact that fiscal policy has produced such huge deficits? I think we have generally agreed that an important reason for high interest rates in the long-term sector is high deficits and the expected return to inflation.

Mr. VOLCKER. To a substantial extent that does block it. It is obviously not within our control.

Senator BRADY. So that your ability to do too much which wouldn't be regarded as monetizing the debt is blocked off by the fact that fiscal policy really hasn't left you with the options that you would have if that policy were restrained?

Mr. VOLCKER. That is correct.

Senator BRADY. I don't have any further questions.

The CHAIRMAN. Senator Sarbanes.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Chairman Volcker, the paper in the last few days has the headline "With Elections, Fed Chairman Gets the Lunch Touch."

I think we'd be interested to know what the lunch touch was and what it was you were getting at those lunches.

Mr. **Volcker**. Perhaps that gives the wrong impression. Perhaps I should say I paid for the lunches. [Laughter.]

Senator **Sarbanes**. That puts the conflict-of-interest question at rest, perhaps, but it still doesn't address the question of the substance of policy.

Mr. **Volcker**. The point I'm making is that I have conversations with the relevant officials of the administration from time to time. In particular, I met with Mr. Meese some time ago—quite a few weeks ago. I happened to meet with Mr. Baker much more recently, and I meet with the Secretary of the Treasury very frequently.

These are just things that are done——

Senator **Sarbanes**. Would you say that the policy the Federal Reserve is pursuing in the monetary area is the policy which the administration wishes it to pursue, that the Federal Reserve and the administration are consonant on monetary policy?

ADMINISTRATION SUPPORTIVE OF PRESENT MONETARY POLICY

Mr. **Volcker**. I am, as I said before, not aware of any real problems in that respect. I think they have generally been supportive of what we're trying to do and the general way we go about it. But I guess you had better address the question to them——

Senator **Sarbanes**. No; I'm interested in knowing your perspective of their view of your policy.

I take it from your answer that your perspective is that they, in fact, support the policy which you are pursuing; is that correct?

Mr. **Volcker**. In general terms, that's certainly my impression; yes.

Senator **Sarbanes**. When you testified in front of the JEC in June, you said that you and the President had discussed interest rates a couple of months earlier.

Was that the last time you met and discussed interest rates and monetary policy with the President?

Mr. **Volcker**. Yes.

Senator **Sarbanes**. You have not met with him since last February?

Mr. **Volcker**. Correct.

Senator **Sarbanes**. Mr. Chairman, I want to say, in the strongest terms, that I think there's a quality of "Nero fiddling while Rome is burning" about this entire discussion.

You have used such phrases this morning as "encouraging signs," "upward momentum," "situation has great opportunities."

It seems to me the one reference in your statement that is pretty close to being in touch with reality is where you talk about the crumbling economic foundations of a continuing recession. Unemployment is at the highest level it's been since before World War II, now at 9½ percent; business bankruptcies are at an all-time high, since before World War II.

We are confronting an economic situation in which this talk about "upward momentum" and "when the recovery takes place" is really not consonant with conditions in the real world.

I'd like to know why you seem to regard lower interest rates as giving up the fight on inflation?

Mr. VOLCKER. I don't regard lower interest rates as giving up the fight on inflation. I would regard it as giving up the fight on inflation if we had an unrestrained growth in money and credit, and that probably wouldn't produce the lower interest rates.

To put it the other way around, I think lower interest rates would be a sign of success and confidence in the fight on inflation if they came about in the right way.

Senator SARBANES. We're getting back a little bit to Senator Brady's question about how to break the gridlock.

You keep referring to the budget problem, and I take it that problem, as you see it, is large deficits, particularly projected into future years when there are favorable assumptions being made about the state of the economy; is that correct?

Mr. VOLCKER. Correct.

Senator SARBANES. Do you concede that the high interest rates have helped to provoke the downturn which we are experiencing, and the increase in unemployment from 7.2 percent to 9.5 percent?

Mr. VOLCKER. In a direct sense, yes. But I don't think that's the whole story. You have to ask why they're so high.

Senator SARBANES. The interest-sensitive sectors of the economy, housing and autos are depressed. Housing starts are now below seasonally adjusted rates of a million units. Housing, which we have always counted upon to some extent to lead us out of a recession, is in a deep depression.

It's my calculation that this increase in the unemployment rate from 7.2 percent to 9.5 percent represents an addition of between $60 and $70 billion to the Federal deficit.

Do you differ in any marked way with that calculation?

Mr. VOLCKER. Certainly the weak economy contributes to deficits. I don't know about your particular calculation, but the recession has a substantial impact, which I think, to a degree, you should abstract from in your budgetary decisions, as I indicated earlier.

Senator SARBANES. The higher interest rates also increase the carrying charge on the Federal debt, is that not correct, and thereby also contribute to an enlargement of the deficit?

Mr. VOLCKER. In a direct sense, yes.

Senator SARBANES. In fact, Walter Heller, in a column not very long ago, said "the Reagan mix of ultra-easy fiscal policy with ultra-tight monetary policy boosts both interest rates and the Federal debt and thus will cost the Treasury an additional $40 billion or so per year.

How long can the country endure current economic conditions without a fundamental loss to the Nation's productive base and to its social fabric, to which jobs and housing are essential?

Mr. VOLCKER. I don't know the answer to that question. My expectation is, of course, that the economy will begin showing some recovery.

Senator SARBANES. You've been telling us that for a long time. I don't want to drag out your past statements.

Mr. **Volcker**. I think you can drag out my past statements and find I've been very consistent in saying that I expected some leveling of the economy in the second quarter.

Senator **Sarbanes**. Some leveling? Do you call the highest unemployment since World War II as some leveling?

Mr. **Volcker**. Yes; some leveling in the second quarter, and I expected some recovery in the second half of the year. That remains my expectation. I didn't say it was satisfactory. I say, technically, it does not appear that the gross national product declined in the second quarter. I'd rather see that than see a decline.

POSSIBILITIES OF LOWER INTEREST RATES

Senator **Sarbanes**. Let me ask you this question. If lower interest rates would have given us more economic activity, avoided the rise to 9.5 percent unemployment, held down the carrying charge on the Federal debt, and therefore represented potentially, let's say, a contribution of $75 billion toward the deficit, then why wouldn't a policy of the Fed for lower interest rates—and I'm not talking about opening the floodgates, but about interest rates at a level that would permit something approximating normal activity in the interest-sensitive sectors—have been a major contribution to moving the economy forward, a major and responsible contribution, without reigniting inflation?

After all, the inflation you're concerned about you tied to the deficit. And the deficit is related to the high interest rates which have provoked the economic downturn.

Mr. **Volcker**. I think the trouble with that line of questioning, Senator Sarbanes, is that it assumes we have some magic wand we could wave to produce a lower level of interest rates without all those other side effects that you have just assumed away. I haven't got all those powers.

Senator **Sarbanes**. Do you have the power to lead us toward lower interest rates?

Mr. **Volcker**. Not regardless of economic conditions, no.

Senator **Sarbanes**. And what is the relationship that you see in terms of inflation with lower interest rates at a time when the economy is working so far below capacity, as it is today?

Mr. **Volcker**. I'm not sure I understand the question.

Senator **Sarbanes**. Suppose we had interest rates today at, let's say, 12 or 13 percent.

Now, how would that contribute to inflation?

It would seem to me that that would contribute to economic activity that would help to lower the deficit, bring down the carrying charge. The deficit would be lower.

Mr. **Volcker**. I don't know what interest rates you are referring to. Some interest rates are below 12 or 13 percent. Some are above.

Senator **Sarbanes**. That's not much comfort for the people in homebuilding and other sectors.

Mr. **Volcker**. I agree it's not much comfort to them.

Senator **Sarbanes**. What's going to happen to them?

Mr. **Volcker**. You assume I can say interest rates are going to be 8 percent or wherever you want them, and that nothing else is going to happen, and that's going to be a wonderful thing for the economy.

If I could just dictate that interest rates are going to be 8 percent, without any adverse effects, that the money supply is going to be on target, and that the deficits are going to be fine, I would go do it. I haven't got that kind of power.

Senator SARBANES. Is there a relationship between the money supply and the interest rates?

Mr. VOLCKER. A complex relationship.

Senator SARBANES. Do you control the money supply? Do you care to accept that proposition?

Mr. VOLCKER. We certainly influence the money supply.

Senator SARBANES. For years, the Fed focused on the interest rates, which are, after all, the variable that the people in the economy have to work with.

You departed from that a few years back. I don't see that that departure has enabled us to develop a policy to keep the economy moving on some reasonable track.

Mr. VOLCKER. I think we have made a lot of progress in some directions, and we have had very heavy costs in the short run.

Senator SARBANES. I'm not ignoring the problem of inflation, but I think any economic policy that does not address both the problem of inflation and the problem of full employment is a failure. It's got to address both of those issues.

We now have a situation where we have the highest unemployment since before World War II. And in some States, the figures, of course, are double digit. Now, there are people, who see everything they've done over a lifetime being lost, both workers and businessmen.

COUNTERPRODUCTIVE

And I don't see that the policy of the Fed and the administration—because, as I understand your opening comments, your policy is in harness or in tandem with the policy which the administration wishes you to pursue is anything but counterproductive. It is helping to compound the very situation which you say you are concerned about.

You talk about the size of the Federal deficits, and yet we can trace, albeit in a complex way, a good part of those deficits to a monetary policy which has helped to promote the economic downturn.

Mr. VOLCKER. Obviously, I don't agree with that analysis. I have indicated that that part of the deficit that can be attributed directly to subpar economic performance should be analyzed in a different way.

I do agree with your basic comment that economic policy in general and monetary policy in particular has to be concerned with all the characteristics of our economy. Where I guess I disagree, as a practical matter, is that we can instantaneously achieve all those things.

Let me point out that the kind of problems you described for the American economy, which are very real, are absolutely endemic among other industrialized countries. You can take practically any country in the Western world today and find that unemployment is at the highest level in the postwar period.

Senator **Riegle**. What's the prime rate in Japan—interest prime rate? I think it's 5¾ percent.

Mr. **Volcker**. I don't know what the prime rate is in Japan. Interest rates are much lower. Japan has the best economic performance of any of these countries. They have a very low inflation rate. But even Japan, relative to its performance, has not been growing very healthily; it's not growing at all now.

Senator **Sarbanes**. They're all related.

I keep getting notes. My time is up.

They're all related to the high interest rates in this country.

Was not that a subject on the agenda at the Versailles Conference?

Mr. **Volcker**. Yes; but I think it's oversimplified to trace all the problems in the world to particular interest rates in the United States.

Senator **Sarbanes**. I'm not trying to do that, Mr. Chairman.

I recognize the complexity of the problem. But the point I'm trying to make is that your presentation, as you continually give it to the committee, seems to posit that any move to lower interest rates is giving up the fight on inflation, but that is, first, not accurate and, second, sends the wrong message to the country.

It's my contention that we could move toward lower interest rates in a reasonable fashion. Again, I'm not talking about opening the floodgates, but moving toward lower interest rates without igniting inflation, helping to restore activity to the economy and, in fact, making a contribution both to the fight against unemployment and to the fight against inflation.

Mr. **Volcker**. To the extent that's possible, maybe we aren't in any disagreement. I agree with you. My only disagreement is whether one can force that development regardless of whatever else is happening with respect to monetary growth, credit growth, the economy in general. I just can't force that.

I agree it would be very desirable to have that happen, and I think it can happen.

Senator **Sarbanes**. We have got to move in that direction.

I don't think it's adequate to talk about hopeful signs and say the situation offers great opportunties at the same time that you can concede that there is a crumbling foundation of continuing recession.

The **Chairman**. Senator Dixon.

Senator **Dixon**. Thank you, Mr. Chairman.

Mr. Chairman, I'd like to switch gears with you for a minute and then come back to the economic question.

First of all, I want to say I was delighted to hear your expression of support for a line item veto power for the Chief Executive.

I would like to tell you that immediately prior to our Fourth of July break, on the occasion of the second veto of the urgent supplemental by the President, I made a statement in the Senate supporting the line item veto and said I'd introduce a constitutional amendment on that line.

And I expect to offer an amendment to the budget-balancing amendment giving the President that power.

In my State, the Governor has a line item veto power, with a right to override in both legislating bodies by a constitutional majority and save millions of dollars there.

I think it would have a very, very good impact upon the budget-balancing capability of the Congress at the present.

So, I thank you for your remark.

Mr. VOLCKER. I didn't realize you introduced that amendment. I congratulate you.

Senator DIXON. One other thing I'd like to pursue with you in connection with what Senator Cranston discussed with you is the question of the amendment that will be before us again when we leave the tax bill.

As you know, in section 3 of that amendment, the three-fifths majority can be waived upon the declaration of a war.

AMENDMENT FOR NATIONAL ECONOMIC EMERGENCIES

I am going to offer an amendment that would extend that power to national economic emergencies.

And I wondered if you would express your view on the importance of having that waiver power when we encounter either very serious recessions or depressions, as we have in the past?

Mr. VOLCKER. I certainly understand what you're after. I suppose in those conditions you'd get the 60-percent majority anyway. I would support the substance of what you are saying. I don't know whether you mean you would leave that up to a Presidential declaration or what.

Senator DIXON. It would be necessary to have an enactment by the Congress and signature by the President, so it would be a joint effort of both.

Mr. VOLCKER. I appreciate what you're after. I'm a little cautious about getting into detail on a piece of legislation that I haven't seen and analyzed more completely.

Senator DIXON. Mr. Chairman, I'd like to pursue a little bit what my friends from Indiana, New Jersey, Maryland, and others have pursued with you here, and that is the question of the basic policy that you have adopted at the Fed. Early on, after your remarks, I made a note on my first page, "more of the same." I don't mean that critically, but would you say it is a fair analysis that you have come to this committee essentially during my short tenure here, telling us pretty much the same things, advocating pretty much the same policies both by the Congress and by the Fed, as the appropriate solution to our problems.

Is that a substantially true statement?

Mr. VOLCKER. Yes.

Senator DIXON. Basically, a monetary policy that you have pursued in the past, one that you have indicated to us again in your statement today, one you perceive to be the solution to our problem. But I would want to ask you whether, in fact, the evidence is not to the effect that so far that policy has not worked in the country.

Mr. VOLCKER. I think the evidence is that it's extremely difficult to turn around in terms of inflation. I think those difficulties multiply when so much of the burden falls on monetary policy. I think those are very substantial problems, but I don't conclude from that that I know of a better policy, because I think we've got to deal with these problems, using the tools that are at hand.

Senator DIXON. If I might pursue that for a moment with you, Mr. Chairman, sometimes I think I hear from you and others in this committee and here on the Hill different things and sense of perception here of a different world than I find when I go back to my home State of Illinois—I was back there this past weekend—unemployment is 11.3 percent. Housing starts in my State were down the most in the country, down 77 percent last year under the prior year, which was a terrible year. I spoke in Rock Island County this weekend, 26,000 people are unemployed, looking for work and want to work in Rock Island County. The automobile industry is decimated. Every one of my thrifts is against the wall and coming here, telling me they're hanging by their fingernails. I'm asking whether in that circumstance our policy can be described as adequate, and I pursue that by saying this: others have alluded to the fact, my friend from Wisconsin has, and others, to the fact that before October 1979, we also targeted interest rates. There were some other things in your policy that, at least in the perception of people I know, now appear to be rational policies applied to a given set of circumstances.

I ask you whether you have ever considered that policy, once again given the very serious times we've had.

Mr. VOLCKER. Let me describe the policy we had before October 1979. We also were targeting the money supply then. We put more weight on very short-term interest rates as an instrument to achieving this same target that we are now aiming at. I'm describing a difference in mechanism to achieve the same target, not a difference in targets. The operational variable, so to speak, has changed; we now much more importantly target reserves rather than trying to influence the Federal funds rate from week to week. The previous policy did not necessarily dictate that given the same monetary targets you would have had lower interest rates. We would have aimed at the Federal funds rate as the variable in the short run, but we might have had to go to a very high rate to achieve the same control over the monetary target.

I think it's fair to say the difference between that technique and the present technique is that we had more short-run stability in interest rates, at least in the short-term rates, under the old technique, but I don't think it said anything about the level of the interest rate.

Senator DIXON. But the very nature of the stability of those interest rates in my view had a lot to do with the continuation of that stability. One of the things I see in the very high long-term rates is the fear of future inflation and other adverse experiences that'a keeping that market so high, when under ordinary circumstances, real interest rates, over and above the inflation rate, would be 2 or 3 percent. Now it's substantially more than that over the inflation rate.

It just seems to me, and I don't mean to be overcritical of what I consider to be your tenacity and coolness under fire, but it does seem to me that the point is that in the past those policies have produced a better result for the economic commmunity.

Mr. **Volcker**. One of the reasons we changed—there were a variety of reasons—is that the decade before 1979 had been characterized by rising inflation and progressively poorer economic performance, I might say, over time. We had higher unemployment at the end of that decade than we did at the beginning. We had a lower productivity trend and higher inflation. By the end of the decade, the threat clearly was that the inflation rate would accelerate and economic performance would continue to deteriorate. The change in approach was designed to make the point and to implement the point that the monetary aggregates would be brought under appropriate control and that the inflationary tide would be turned.

With respect to that particular objective, I think there's been a good deal of success. We've also run into a real problem in the economy while these changes are taking place.

Senator **Dixon**. Could I make this point, Mr. Chairman, that I would concede, as every member will, the results with respect to inflation from your stated policy, but I have to say to you that we have had deficits in all but 1 year in the last two decades. To the best of my recollection, the deficits have been there. I can tell you this, however, these are the worst economic times we've had in my adult lifetime. So there has to be some reexamination of some of the policies that we are following around here, if we're going to turn this thing around.

It at least seems to me that we ought to look back to what we did before, if it was a better result.

Mr. **Volcker**. Obviously, I agree with you that policies ought to be reexamined, and I do not think our total mix of policies is ideal, to say the least. We are only dealing with one aspect of policy now, monetary policy. When you talk about changes in policies, presumably, you talk about the whole framework of policy. We have fiscal problems. I am personally very sensitive to the kind of problems Senator Lugar raised, which I don't think anybody is working on very much, but over time should be.

They are a very difficult, intractable set of problems, and when I look to a longer run, I think they have to be an important component of a successful economic policy that, indeed, reconciles stability with growth.

I think we can get that out of our present policies, but it will take longer and yield much more distress than would otherwise be necessary.

Senator **Dixon**. Then let me ask this final question. Again pursuing the question of that policy with reference to targeting interest rates as have been done prior to October 1979 and reverting one more time to a classic example of a really troubled industry, thrifts, which I suppose in my State are in more difficult circumstances than many others. It came to my attention the other day, for example, that right now the Federal National Mortgage Association is earning about 10 percent on its portfolio, but is paying over 11 percent for its capital. I want to ask you, given the circumstances, how much longer that kind of an industry can tolerate these rates before something dramatic happens in this country that is destructive to our market?

Mr. **Volcker**. I have no quarrel with the proposition that we would be much better off if interest rates were lower. The only question is how to get them there and keep them there. I have no quarrel with that proposition at all.

Senator DIXON. I thank you.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

SMALL BUSINESS BANKRUPTCIES

Mr. Chairman, we've had a lot of discussion here today of esoteric economic theory, but the simple truth is that small business is being crushed in this country. In my native State of Tennessee, small business is being snuffed out of existence by high interest rates. I recently contacted the administrative officer of the bankruptcy courts in my State, and I was absolutely flabbergasted by these statistics.

In the first quarter of 1981, there were 395 business bankruptcy filings in my State. In the first quarter of 1982, there were 701 business bankruptcy filings. That's a 77-percent increase in business bankruptcy filings from the first quarter of 1981 to the first quarter of 1982.

Now I contend, as my small business constitutents have confirmed, that their businesses have failed or are on the verge of failing largely as a result of high interest rates. They are paying 18 to 20 percent to borrow money for capital, and small business just simply cannot last or last very long in that sort of environment.

Now my question to you is this: What does the Federal Reserve Board intend to do to ease the interest rate burdens on small business, or are you just going to stand by at the Fed and watch this rising tide of bankruptcies go on and more and more small business people go under? Can you give us some hope, Mr. Chairman? A lot of these people are living on hope.

Mr. VOLCKER. I certainly can give you the hope and the expectation that interest rates will move lower over time. I think the fundamentals point in that direction. No one would be happier than I to see interest rates move lower, but we come back to the old question of how can that be done within the scope of the tools available to monetary policy, not only getting them lower, but getting them to stay lower. We come back to these same old questions of gridlock or problems that have looked quite intractable. I think, in fact, they are going to prove tractable, and what's going to make it all possible is a sense of progress on inflation and continuing progress on that front to lay the basic groundwork.

Senator SASSER. Let's talk about that just a moment, Mr. Chairman.

Now we have today the highest real interest rates, that is, interest rates corrected for inflation, that we have had in this century. Just looking at some numbers here, in October 1979, we embarked upon a new monetary policy under your leadership. At that time in 1979, the prime rate was roughly 12 percent; the GNP deflator was 8.5; and we were running real interest rates of 4.1 percent. By 1980, the prime rate was up to 15 percent; the GNP deflator was 9 percent; and the real interest rate was 6.3 percent. In 1981, the prime rate jumped to 18.8 percent, with the GNP deflator at 9.2, meaning real interest rates were at 9.7, almost 10 percent. And in

1982, with inflation coming down—no doubt about that—the prime rate's at 16 percent, the GNP deflator at 3.5 percent and real interest rates at 12.6 percent.

INTEREST RATES CONTINUE TO RISE

Now my question is this: if our policy is to try to drive down inflation with high interest rates, it appears to me, Mr. Chairman, there's been some success in that regard. Now why are interest rates continuing to go up, and why do we have real interest rates at the highest point in this century? What's the answer to that?

Mr. VOLCKER. Interest rates, real interest rates are very difficult to measure. Let me make a preliminary comment. It's hard to measure what the precise inflation rate is, and real interest rates really depend on a determination of what expected inflation is, rather than on any rate you can measure directly.

The prime interest rate is extraordinarily high historically, relative to market rates at the moment. You would not get a different picture in character, but you would get a different picture in the extremes that you cite if you used an interest rate other than the prime rate.

Having said all those things, real interest rates are certainly relatively high. I don't think it's true that they're the highest they've been in the century, but that's besides the point. They are very high; there's no question about that by any reasonable——

Senator SASSER. You wouldn't agree that they're the highest they've been since 1900 in real terms.

Mr. VOLCKER. If you make a mechanical comparison between interest rates and the inflation rate, you'll find a few episodes when they were higher. They weren't very happy periods in economic history, so I won't pursue that point further, but such rates are not totally unprecedented. They're very high; there's no dispute about that fact.

You come back to the question of why, how do you get them down, what's responsible for it? Going back to late 1979, early 1980, we begin to look at that period, I guess, with a little nostalgia. It wasn't a very nostalgic period to live through. The inflation rate was accelerating, everyone was scared to death about what was happening to the economy—and rightfully—and about inflation.

Senator SASSER. They're not very sanguine about what's happening to the economy now.

Mr. VOLCKER. I agree with that, which is indicative of the fact that we've got a problem. It was not born yesterday, but developed over a considerable period of time. Again, it comes back to the question of what approaches can we best adopt to deal with that? I have described what we try to do with monetary policy. I have indicated that we are sensitive to the liquidity needs of the economy. Unfortunately, we have just one tool of economic policy, and we are dealing with an accumulation of problems over a period of time. I can only tell you what I think is best, even in explicit terms, for getting interest rates down and, as I keep emphasizing, not just getting them down for a month or two but sustaining a lower level, in terms of the tools we have at our command.

Is it a happy situation? No, I'd much rather see interest rates lower, and I would be delighted to see them decline as rapidly as they can, consistent with what I think is necessary to keep them at a lower level.

Senator SASSER. The disturbing thing to me, Mr. Chairman, is that when we embarked—I say, "we," the Federal Reserve Board embarked on this course in 1979—I remember vividly your telling us in the Budget Committee in the spring of 1980 that high interest rates were a product of inflation, and that they would drive inflation down. Some of us were unconvinced at that time; in fact, I've never thought that you can combat inflation strictly with monetary policy. We now find that inflation is coming down considerably. I had some statistics here earlier that indicated that the GNP deflator for the first quarter of 1982 is 3.5 percent; down dramatically, yet we still find our interest rate figures high and our real interest rate figures high.

We see that inflation is coming down, but interest rates aren't coming down. And we see our economy in very, very serious difficulty now. Comparing this recession of 1981 and 1982—and I'll yield to you in just a moment—comparing the recession of 1981-82 to the recession of 1973-75, which was a very deep and a very severe recession, we find that in the recession of 1981-82 corporate profits are off 30 percent, as compared to only 23 percent in the previous recession. We find there are 2 million more people unemployed in this recession than there were in the 1973-75 recession, and we find mortgage delinquency rates are up almost 20 percent.

All of this is occurring. Inflation is coming down, but interest rates in real terms are at one of the highest levels, I think we'll agree, in the century.

Mr. VOLCKER. One of the highest.

Senator SASSER. That clearly indicates to me that something is wrong with this policy that we are pursuing. And if we don't reverse it, Mr. Chairman, I have some very grave fears that we're going to be in desperate straits, if we're not already.

Mr. VOLCKER. Again, I think I have to answer the Senator by saying that I'm sure there can be, and should be, improvements in economic policy in general. I think that some degree of difficulty in this present situation was inevitable as a transitional matter. But if you asked me whether it could have been handled better through a different combination of policies, I would certainly agree with you.

PRESSURE ON MONETARY POLICY

Indeed, I think too much of the burden was put on monetary policy, which helps account for the high interest rates.

Senator SASSER. No doubt.

Mr. VOLCKER. There is no question that when monetary policy carries the full thrust of reversing an inflationary situation, you are likely to have more pressures, strains, higher interest rates than would otherwise be the case. That's not the world that I made or that the Federal Reserve made; that's the world that we live in. Anything that could be done in any other area to help out, I would welcome.

I do think that this pressure on monetary policy is partly responsible for what you observe with respect to interest rates. Where I may differ with you is whether interest rates should follow a substantially different course, given the environment in which we have to work.

Senator SASSER. One final question, Mr. Chairman. My time is up and I will be very brief.

Recently, U.S. News and World Report stated—quoting David Stockman—that the administration endorsed the Federal Reserve's tight money policy. Mr. Stockman said of the Board's monetary policy—and I quote—"We endorsed it, we urged it, and we have supported it."

Well, almost contemporaneous with that, on Good Morning, America the Secretary of the Treasury, Mr. Regan, stated—and I quote him—"High interest rates have brought this economy right to its knees." And he indicated he directed the Treasury Department to study various alternatives that the administration might pursue, to lower interest rates or otherwise curb the independence of the Federal Reserve Board.

Now, in your mind, Mr. Chairman, where does the administration stand on this monetary policy?

Is David Stockman right? Have they endorsed it? Have they urged it? Do they support it?

Or is the Secretary of the Treasury correct, in being critical of it and directing studies to try to lower interest rates and perhaps even do something about the independence of the Federal Reserve board?

Mr. VOLCKER. As I indicated earlier, in response to Senator Sarbanes, my perception is that they've been generally supportive of the thrust of monetary policy.

Senator SASSER. So, Mr. Stockman is closer on the mark when he says "we have supported," than the Secretary of the Treasury is when he says he's critical of it?

Mr. VOLCKER. I suppose those are questions that have to be directed specifically to them.

Senator SASSER. Thank you, Mr. Chairman.

Senator BRADY. Mr. Chairman, I think I have 1 more minute. Might I ask one more question?

The CHAIRMAN. You quit 2 minutes early on your last round.

Senator BRADY. Thank you.

Mr. Chairman, I think that I heard you say no one would be happier than you to get lower interest rates.

Is it, therefore, a further conclusion that it's the way you get them that is your——

Mr. VOLCKER. At issue, yes.

Senator BRADY. It seems to me that it's worthwhile noting that you are Chairman of the Fed, and not economic dictator; you only have certain tools to work with—three, I believe: operations of the Federal Open Market Committee, the discount window, and reserve requirements. Any pushing or aggressive actions in those three areas are going to return us to where we were in 1978 and 1979. As I have heard you speak this morning, it seems to me that lower interest rates are your goal; if you could mandate them, fine.

But your feeling is that you don't have any such tools before you?

Mr. **Volcker**. If I could mandate them, and have all these other happy things happen with no adverse effects, I would mandate them this morning.

Senator **Brady**. Let me ask you one more question, then:

When you put into place the policy, in 1979, that is now in place, what would have happened if you had not done that?

Mr. **Volcker**. What we were dealing with, fundamentally, was accelerating inflation. We let that go and get out of hand; even now, we would be in much more serious economic difficulties had we not dealt with it. You can argue about the particular technique, but that fundamental need to deal with and turn around an accelerating inflation seems to me unambiguous, otherwise we would have been left in much more serious economic circumstances, over a much longer period of time.

Senator **Brady**. How would it have manifested itself?

Mr. **Volcker**. Among other things, it would have manifested itself in still more serious problems in financial markets and in higher interest rates.

Senator **Brady**. Were we headed toward the economies in South America, where you have rates of inflation——

Mr. **Volcker**. I don't want to be overly dramatic, but we were certainly going in that direction. We were a long ways from there, but that's the way things start. The longer it lasts, the more it accelerates, the harder it is to deal with.

Let me just make a point I try to make with practically every audience: never before in the history of this country have we had an inflation of the size and duration that we have had since 1965. I think that left a very great imprint on people's minds, their behavior, their attitudes, their willingness to buy long-term securities, and the way they look at interest rates. All those things grew out of the unparalleled inflationary episode that we had in this country.

Senator **Brady**. I think that it's worth noting—one more observation is that we have in this country the only long-term bond market in the world. I believe that is correct?

Mr. **Volcker**. That's right. And that has been, and is, threatened.

Senator **Brady**. Thank you.

SAME DEBATES AND ARGUMENTS

The **Chairman**. Mr. Chairman, I would like to use my last period of time to express some great frustration, as I have listened to these hearings today, and also sadness. And the reason I say this is that I never seem to hear much different. I've sat on these hearings, now, for 8 years. It's almost like picking up the newspaper in Salt Lake City. It's been 8 years since I was mayor there, but yet, I pick up the newspaper out there and read about the present mayor and the struggles of the city council; and the news is the same, they are having the same debates and the same arguments over and over again.

After 8 years on this committee, I see the positions shift, but not too much different is going on.

Today we have here a great effort—not only here, but across the country, and on the floor of the Senate, and all the committee meetings—there is a great effort for Congress to pass the buck; not just one party, but both parties—to you. You are one of the favorite topics of speeches by Congressmen and Senators of both parties, all over this country: If we could just get Paul Volcker to do something, all this would go away. Never much talk about fiscal policy; never much talk about our role in it.

And the second target is Ronald Reagan. I realize his program has been in effect since last October.

You are No. 1; he's No. 2. "The two of you have destroyed the economy in the last year and a half," without any regard to historical significance of a trillion-dollar debt that was built up before either one of you were around, of refunding one-third of that debt, of $340, $350 billion a year—just ignoring the arithmetic completely.

This isn't a partisan statement I'm making, because you were here when Jimmy Carter was President. And my side was sitting here, asking the same kinds of questions that you've heard today: "Have you been having lunch with Jimmy Carter?" "Does Jimmy Carter agree with your policies?" All we've done is change the roles and the parties.

That's where my frustration and sadness come in, because what we've heard today is true, from everyone. This economy is sick; it's very sick. And we're switching roles, regardless of which party we belong to, to try and assess blame on the Fed and whoever the incumbent President is, and ignoring our role.

That's why I'm so frustrated. Congress seems to be getting away with that year after year. Every year I've been here, they get away with it and push it off on someone else.

You can loosen up your money policy tomorrow. Interest rates will probably go up, in my opinion. Or we can do away with the third year of the tax cut. We can cut billions out of the military. We can do all sorts of things. Everything you've heard from everybody, particularly those running for office, Republican or Democrat, who want to find somebody else to blame for these horrible conditions they're having to explain at home.

It seems to me that we've got to get away from that and start looking at the arithmetic. And I'm speaking specifically of long-term interest rates. I simply know of no actions that you can take, no actions that this President can take, because we can bitch and moan about high deficits and everything else, and there's a fact that no one can dispute. And that is: That no President has ever spent a dime not appropriated by the Congress of the United States. Not George Washington, Abraham Lincoln, Harry Truman, Jimmy Carter, Ronald Reagan, or anybody else.

So, if we really don't like these budget deficits, why don't we just shut up and do something about it.

Congress is the only one, under the Constitution, that can appropriate money. If we don't like a $100 billion deficit, we can do something about it—and no one else. The President can recommend, he can plead, he can threaten, he can veto, he can twist arms; but it is a fact that only Congress can appropriate money.

So we're involved in so much rhetoric about these deficits, trying to push it off on you or someone else. That doesn't mean that I agree with all of your policies. I don't; you know that and everybody else does.

But it is internal within our budget process to solve this interest rate problem, particularly in the long term, because nobody is going to be fool enough to loan money over a long period of time, at reasonable interest rates—I'm not talking about short term. You can have some influence over short-term rates.

But if they sit there and see half a trillion deficits in the out years because we're so gutless that we won't even talk about social security and veterans' pensions and Federal civil service retirement and the entitlements programs that are automatically indexed and growing at an incredible rate, we're not going to solve that problem and interest rates won't come down.

We can make any of these critics Chairman of the Fed tomorrow. I would like to make some of them Chairman, and put the whole thing on them. And I bet you they would be up here saying, "Hey, I don't have that much power." [Laughter.]

"Good heavens. I can't do anything about that."

I just want to make the point. I'm not trying to blame anybody. I've got seven kids. I would like somebody to tell me how they're going to buy a house, what we're going to do about this long-term market. This President can't do anything about it. You can't do anything about that long-term market. Only we.

When we have the courage to say to the American people, "Yes, we have got to talk about slowing the growth of social security, not cut anybody."

I was talking to a pressman the other day, in Atlanta. He just didn't seem to understand. So I said, "OK. I can't seem to get through to you that no one is talking about eliminating anyone from social security. No one is talking about dismantling. No one is talking about reducing anybody's pension from their present levels. But we must talk about making that system solvent, and we must talk about slowing the increase."

So, I said, "What if you just demanded of your boss that you were the greatest living media reporter the world had ever had, and you wanted a $10,000 raise. And your boss said, 'boy, you really have done a fantastic job and I'm going to give you a $6,000 raise; that's all I can afford within my budget.' "

"So you run home to your wife and you say, 'That lousy boss of mine just cut our pay by $4,000 a year.' "

Now, that's what we're hearing. No one in this town is talking about cutting anybody's social security, but until we talk about slowing the growth of those entitlements programs, you can balance the 1983 budget tomorrow, and I think everybody would be still surprised. They would say, "Why are long-term mortgage rates still so high?" Because we haven't scratched the surface of the budgets in 1990 and 1995.

A 30-year mortgage is the year 2012. We're worried about a 1983 budget—which we should. It's too big. The deficit is too large. But this Congress has not yet faced up to those out years. And interest rates will not come down, and the American people better learn where the problem of long-term interest rates is. It isn't in the Fed. It isn't in this administration, in the Carter administration, or any other place. It lies with the people who have the power of the purse strings, and nobody else. The Constitution says so.

We've got the power to do something about it. And until we do, the wrath lies on this body—the Senate and the House, on both Republicans and Democrats—who ought to be penalized in this election in November if they haven't got the guts to address these issues and do something about them.

That's hardly a question period. It was a speech. But it was intended that way because, like I say, the bottom line with me is: How do my seven kids grow up in this country and buy a house? Right now they couldn't possibly even hope to buy one.

Senator Riegle.

Senator **Riegle**. Senator Garn, that's a tough speech to follow right now. I appreciate and share many of the frustrations that you expressed, but I want to try to nail down where we are going from here with Chairman Volcker, because I think we are moving into a period of extraordinarily high risk to the economy. I think we are into a period in which I think the jeopardy is rising, as we last saw just before the Great Depression, and I think what is required here is to steer a course, a change in course that can take us through these difficulties and bring us through without a far worse financial collapse than we've already seen. And we do have a financial collapse occurring now. You can measure it, as many members of this committee have today, by unemployment, depression in the housing industry.

In my State today, in Michigan, the unemployment rate is 15 percent. That does not count 125,000 workers who have been unemployed so long they are no longer included in the unemployment numbers. In my State we have had unemployment above 10 percent for 32 consecutive months. Every day my phone is ringing from business people across the State of Michigan, from large corporations down to the smallest businesses, telling me they can't survive another month, another 2 months. They are filing for bankruptcy, they are going into chapter 11.

Everywhere I look, that is what I see. It isn't just Michigan; it is true across this country, and I've been across this country in the last 30 days talking with people in different places, and this is what I am finding.

I don't sense that there is a recognition yet within the Fed of the magnitude of this problem, and despite the good personal relationship that you and I have and which I want to maintain, I don't sense in your remarks today that you perhaps comprehend the magnitude of the human suffering and the devastation that's going on at the foundation of this economy, that I am not sure we are going to be able to correct, or if we do, it may well take us decades to do it.

ADMINISTRATION TO STAND PAT ON ECONOMIC POLICY

I think we are about to move into a period of free fall on the economy. What people are not paying attention to is the Federal

Government, for all practical purposes, is about to shutdown for 6 months. That's what's happening. As a matter of fact, in the U.S. News and World Report of yesterday, which is pretty well tuned into the White House, what they say here on page 11, they say:

> The President will stand pat on economic policy for the rest of the year. Reagan won't be turned around, even though the oft touted just around the corner recovery is looking more and more elusive. Political realism is the key. There is not much the President can do between now and election time to give the ailing economy a quick fix. White House game plan is to tough it out, insist Reaganomics will work, and hope things will perk up soon enough to prevent heavy losses in Congress this fall. The last thing Reagan wants to be accused of is Carterism, being wishy-washy on major issues. Reagan's advisors argue his steadfastness is a virtue, shifting gears would send bad signals to financial markets and voters.

I think this is probably accurate. They don't intend to make any change, any mid-course correction in the policy; nor fight to try to bring the deficits down. It can't be done in this country without the President participating. The President is the single most important leadership figure in this country. That is why he is paid $200,000 a year to do the job. He can't sit up in the bleachers and complain about the problems and not participate directly. However, we've not had that kind of direct participation and the Congress itself has not responded.

The deficits are out of control, and I don't know of any economist in the country today that believes the deficit estimates in the first budget resolution, which is nonbinding that reported that deficit of $104 billion next year. Deficit estimates range way beyond that point, and they are clearly much higher than we can tolerate. But the problem is that once we shutdown here, there are no emergency powers in place today that anybody can operate.

If we find the economy worsening, the Credit Control Act has just expired. You, in effect, said there is very little that you can do. The President, for his part, not only doesn't want to do anything at this point, but it's not clear what emergency powers he has to use in the period of time that the Congress is not even in session, can't even meet short of an emergency joint session of the Congress. And people like Henry Kaufman and Wosinauer, who have great respect in the financial markets, as you well know, are predicting that interest rates are about to go back up. You may have a momentary drop in interest rates, partly driven by the reduction in the discount rates yesterday, but their expectation, which is widely shared in the financial markets and amongst financial experts across the country, is between now and the end of the year the interest rates are as apt or more apt to be going higher, maybe not to 20 percent but certainly back up to 16.5 or 17 or 18, and as Senator Sasser points out, there are small business people in this country who are not borrowing at 16.5 percent—they are borrowing at 18, 19, and 20 and they are going down the drain.

You talk about the other Western economies. I look at Japan; the prime rate in Japan is 5.75 percent. Their people are working. Our people want to go back to work and they have a right to go back to work. But I think what everybody is failing to see here is that we are about to go into a period of maximum risk and jeopardy in this economy where, if things do get much worse, if interest rates do go higher, we could find the financial structure and everything else put in jeopardy beyond anything we have seen since the 1930's.

We are seeing bank failures. We are seeing a quiet run on financial institutions. We are seeing people move out of long-term securities into short-term securities, and basically what everybody says is, "Sorry, we can't do anything about it." And in effect, that's what you're saying today. You are saying your hands are tied, there is not much you can do.

What I am saying to you is that if that is the attitude everybody is going to take, if the Fed is going to take that view, the President's going to take that view, the Congress—and it is divided; one party controls one body of the Congress, the other party controls the other—if the best that we can say collectively is, "Sorry, we really can't do anything about this problem," then that's a pretty sorry admission of the failure on our part to respond to an emergency. That's what we have on our hands.

I just want to conclude by saying this: I've talked to the top financial officers of the major banks in this country at major financial institutions, every single day, and I have for the last 30 days straight. They share this view. This is their view, this is what they're saying. This is what they're saying in the private conversations. And so this is not just a question of one person's opinion or someone else's. There is great alarm, great fear about where we are heading unless we change this policy mix. Everything that I see here indicates that everybody is prepared to stay on the course we're on, and I see that as posing unacceptable dangers to this country.

I am prepared to go with you and I'm prepared to give people on both sides of the aisle, hopefully, to go as a group to see the President, to see his economic advisors, to meet with a bipartisan group of leaders in Congress, to meet with whoever has to be met with so that we can reach a collective decision, a bipartisan decision to take action now before this window closes, because once this session of Congress ends, we are going to be locked on course.

I had the head of one of the top banks of this country say to me a week ago, he said, "This economy is right on the edge."

I said, "Is it going to go over the edge or come away from it?"

He says, "I don't know." He says, "I think it's as apt to go over the edge as it is to come away from it."

That's the situation we're facing today, and yet there is no plan here. And my question is this: If things do worsen, if things do worsen and we see the unemployment rate go up another percentage point or two, we see the bankruptcy rate continue to climb, we see interest rates start to go back up again, what will the Fed do at that point?

FED RESPONSE TO SINKING ECONOMY

Mr. **Volcker**. You asked the question—I was about to volunteer the response. I certainly understand the sense of frustration that Senator Garn expressed. I understand the concerns you expressed. Let me say as clearly as I can that I don't share your concern——

Senator **Riegle**. You don't need to share it. If it happens, what response will the Fed make?

Mr. VOLCKER. You say we can't do anything. I say we haven't got any wand to wave to get interest rates down in current circumstances and keep them down. In the kind of situation that you're calling up here, obviously we have powers to increase the liquidity of the economy, to respond and protect the banking system and other financial institutions, and we would exercise those powers—there shouldn't be any doubt about it—if that kind of scenario threatened to develop.

Senator RIEGLE. So it would be your plan, if we find the economy continuing to sink, if interest rates start to go back up again, that it would be the Fed's intention to use whatever powers it has if it finds us moving into a greater emergency than we have at the present time, you are prepared to respond? You are prepared to take whatever unilateral actions are necessary to see that there is adequate liquidity in the economy?

Mr. VOLCKER. Yes. If we face that kind of situation, which I don't expect to face, we would obviously use our powers.

Senator RIEGLE. And what exactly would that involve? What would you be able to do at that point? How would you be able to bring the rates down sharply and quickly? I am serious. I am interested in knowing what the mechanical response would be in that case.

Mr. VOLCKER. What we can do is provide more liquidity to the economy.

Senator RIEGLE. How would you do that? That's what I'm asking.

Mr. VOLCKER. Through our ordinary tools of policy: Using open market operations, the discount window, depending upon what was necessary and desirable.

Senator RIEGLE. If interest rates go back to 17, 17.5 percent before this year is out, would it be your intention to respond in this fashion?

Mr. VOLCKER. It would depend upon the whole context of the situation. You just can't pick out one variable and ask me how I would respond. You are positing the threat of a national emergency, of an emerging depression or something like that. I don't expect those things to happen, but obviously we would respond if they did.

Senator RIEGLE. Do you think the economy could take interest rates of 17.5 percent sometime between now and the end of the year, or higher?

Mr. VOLCKER. It would depend upon what else is happening.

Senator RIEGLE. We know what else is happening. We see the state of things at the present time. Do you think this system can take that kind of high interest rate stress at this point?

Mr. VOLCKER. At this point I certainly would not like to see that, but we're not talking about this point in time.

Senator RIEGLE. I can't find anybody today who is in the financial institution world, who is looking at the balance sheet and interest statements of hundreds of thousands of other companies, who feels that this country can sustain that at this point. My hope would be if we find that developing, that you will act. And if the President remains serene and detached from this problem, if the Congress demonstrates an incapacity to respond to it, and in fact it may even be out of session when it develops, I hope you will respond. I hope you won't wait.

Mr. Volcker. We would respond with all the powers which we have, if we thought the basic institutional structure and the basic economic structure were threatened, within the limitations of what we can do.

The Chairman. Senator Proxmire.

Senator Proxmire. Mr. Chairman, I'll be quite brief.

You issued today the midyear monetary policy report to Congress pursuant to Full Employment Balanced Growth Act of 1978. Right after page 13 you have a graph showing the ranges of actual monetary growth. I am asking this because I want to—it seems to me this indicates what you are going to do, in all likelihood, because as I understand you to have said this morning, you don't intend to depart from the monetary targets that you have set.

Mr. Volcker. We expect to be around the upper end of them. We indicated, if special liquidity problems arise, we are prepared to go above that.

Senator Proxmire. As I look at these charts, M_1 and M_2, you just came back to M_1, barely, in the latest figure. On M_2 you are still a little bit above the M_2 target. As you come to the midrange, that would be 4 percent for M_1 and 7.5 percent for M_2. That would be a restriction. You've just said you expect to be in the upper area, so that you would continue with what I think all of us would have to define as a restrained, conservative monetary policy. You would expect to do that for the rest of the year; is that correct?

Mr. Volcker. Relatively restrained. We said we might be around the upper end of the ranges.

Senator Proxmire. The same thing would be true on the table following page 15 with respect to M_3 and bank credit?

Mr. Volcker. Yes; let me point out, as I did in my statement, that with that kind of growth in the monetary aggregates, historical experience would suggest there is quite a lot of room for real growth in the economy at the current rate of inflation.

RECORD BORROWING BY THE TREASURY

Senator Proxmire. I don't want to hash over what we've already been through, because I don't want to take up that much of your time. As I tried to point out, the Federal Government is going to absorb a very large part of the available money supply. There is going to be record borrowing, isn't that true, by the Treasury, the rest of this year and next year, way, way beyond anything we've had before?

Mr. Volcker. Yes, but these are not measures of the total supply of credit in the economy. These are measures of the money supply. The total supply of credit is of a much larger magnitude than these numbers.

Senator Proxmire. That would be reflected, to some extent, in the chart in your statement where you say bank credit (see p. 12).

Mr. Volcker. A part of it would be. The Government doesn't borrow very much from the banks. Actually, the banks don't hold very many Government securities these days, and these would be consistent with the figure for credit expansion that would allow for a very large volume of Treasury financing.

Interest rates are higher than they otherwise would be because of that volume of financing. But, certainly, based upon any analytic relationships we can develop, this kind of growth in money would be accompanied by growth in credit that is consistent with economic recovery in the latter part of the year. If that's not the case, if there are extraordinary liquidity demands that impact on these numbers, I indicated a note of reservation or modification.

Senator **Proxmire**. The reason I have trouble with that is over the past year or two, the private economy has not been able to borrow much because interest rates are so terribly high, and in the next 6 months or a year the Federal Government is going to borrow more. The available supply of credit would not seem to be increased, and therefore it would seem to me it is pretty clear that any objective analysis would suggest we are going to continue to have high interest rates and restrained economic activity for the next 6 months or year. I just can't see any room for recovery.

Mr. **Volcker**. I disagree with that analysis. Our analysis would suggest, on the contrary, that this kind of monetary growth, based on historical experience, would be consistent with recovery. On M_2, for instance, the arithmetic is simple; in recent years it has been expanding about as fast as the nominal GNP. In the past three quarters it's expanded faster than the nominal GNP.

What you would expect, following a period of that sort where these monetary aggregates have, in fact, expanded faster than you might have expected, given what's going on in the economy, is that that would be followed by a period where they are expanding relatively slowly relative to the economy. I'm——

Senator **Proxmire**. But the nominal GNP has been stagnant, the inflation hasn't been that much and the growth in the economy has been stagnant.

Mr. **Volcker**. The nominal GNP has been stagnant, and the technical manifestation of that, consistent with these targets, is that velocity has been low. Experience suggests following a period of low velocity you have a period of higher than average velocities. That's what we're assuming will happen. If that doesn't happen, this would obviously be called into question.

The **Chairman**. Do you feel your monetary policy would accommodate that increase, substantial increase in nominal GNP?

Mr. **Volcker**. Yes.

Senator **Proxmire**. Thank you, Mr. Chairman.

The **Chairman**. Senator Brady, do you have additional questions? May I apologize for placing you after Senator Riegle, but you're so far away, hidden behind the cameras, that I simply missed you.

Senator **Brady**. Thank you, Chairman Garn.

I will only add to what Senator Riegle says about talking to people all across the United States, which I have done myself in the last month or so, only I have come to a different conclusion from my colleague. I got very little comment about what the Federal Reserve is doing and what Chairman Volcker is doing. I got a lot of comment on the subject that Senator Garn has put forward, which is what are you guys in the Senate doing with regard to fiscal policy? What about the size of the deficit? So I think the concern is there about where we're going in this country, what the level of economic activity is. But the people that I talk to don't lay the blame on the Chairman of the Fed or the Federal Reserve System. They lay it right smack where I think it probably belongs, which is on the Congress of the United States.

So I would only add that to what we have already heard this morning. I think we do have—Chairman Garn, you put your finger on it. There is a great sense in this body of ours—let me just point up, having been here for such a short period of time, is that somebody's made a mistake and since we don't make mistakes, somebody else must be making them. And I think the case is more nearly the case that you cited this morning; that we simply have to have more of a fiscal restraint on this body.

The **Chairman**. Might I just say, I share both yours and Senator Riegle's concerns. You know, we do—Congress does have time. We have yet, in either body, to look at an appropriations bill, so we can't cop out on that, that we are going to be out of session. We've got 13 regular appropriations bills to attempt to implement the budget resolution. As meager and unsatisfactory as that budget resolution is, I have doubts about the Congress ability to adhere to it. But we've got time. We've got all the rest of July and August and September. We might even not have to have a Labor Day recess. We've got time to put up or shut up on the 1983 budget, because we have yet to address a single appropriations bill.

Senator **Riegle**. Excuse me. Would you yield, Senator Brady, just for comment? Apart from how one assigns the responsibility for events up until the present time, or even in terms of how we break the gridlock at this point, in terms of the various players playing their roles, and so forth, leaving that aside in terms of the urgency of the moment, the need to break the gridlock and to take the fundamental actions to get us on a different course that can bring rates down, bring down the deficit, and so forth; I don't know whether you're getting the same sense of urgency on that point that I am getting, but I find that to be universal. It's up and down the scale from people at the top of gigantic financial institutions down to the person running a store on the street corner.

Senator **Brady**. I do get that same sense of urgency. I think there is a great feeling throughout the land that things are not right, something has to be done, and maybe even a feeling that the Congress does not understand that.

Having come from the private world just recently, I would say people underestimate their Congress in the sense of what their situation is. I think at least the Senators I've talked to do understand the problem, that that urgency is out there. I would only say to my colleague from Michigan that in breaking the gridlock, we could strike a mighty blow by doing the thing that Senator Garn has talked about, by taking the next appropriation bill that comes through—I do not know what it is going to be, but acting responsibly toward it and give the people of this country the idea that we are going to face the problems there.

My problem talking about monetary policy, is that I do not think it addresses the problem. I think the problem is in the area we talked about, the unlocking the gridlock, for you to have to unlock it at the short end of the market or the long end of the market. I think it is very hard to unlock at the short end of the market right now, and the key is to take an absolutely clear step on fiscal policy. It does not have to continue forever.

I think one of the things we have in Congress is we take a step in one direction, everybody says we're going to continue doing that for the next 15 years. We could make some steps in the next 6 months and see how it works, and turn around and go the other way again, after we get through. So to me, you've got to start somewhere, and I would start with the area of fiscal policy because I think the chairman of the Fed is absolutely boxed right now.

The **CHAIRMAN**. Senator Sasser.

Senator **SASSER**. Thank you, Mr. Chairman. Mr. Volcker, I take it from what you have said earlier that you do not think we can fight inflation just with monetary policy either, do you?

Mr. **VOLCKER**. I think it is much better if we do not just rely on monetary policy. In theory, you can just use monetary policy, but it makes things much more difficult.

Senator **SASSER**. We would be in a better position, I assume, if we had a match of monetary and fiscal policy operating in tandem?

Mr. **VOLCKER**. Yes.

CUTTING TAXES

Senator **SASSER**. I recall your coming before the Senate Budget Committee in 1980 and advising us at that time that we should not go forward with our plans to cut taxes. There was some discussion at that time in 1980 by a number of Members of the Senate; more specifically, Senator Bentsen and others, about cutting taxes. As I recall your testimony in response to questions before the Budget Committee, you advised us against that at that time.

Mr. Chairman, did you give the same advice to the President and this administration when they embarked upon their expansive fiscal policy of cutting taxes? Did you discourage them from doing that?

Mr. **VOLCKER**. Certainly in terms of the magnitude of the program, yes. It all depended upon how much we were to be able to cut expenditures obviously, and I had some skepticism he would be successful in cutting expenditures enough.

Senator **SASSER**. I would say your skepticism about whether or not this Congress could cut some $750 billion in expenditures over a 3½- or 4-year period was well founded.

But I make this point, I think to illustrate that perhaps there is more responsibility here than some of my colleagues are giving us credit for. We turned away from the tax cut in 1980 because we were advised by you and others that that would not be responsible, and yet we then saw the tax cut coming in 1981.

Let me ask you this: Do you think this tax bill that is before the Senate now, which will raise some $91 billion in revenues—does that go far enough in raising the revenues that are needed to attempt to do something about the deficit, or should we go forward and give consideration to deferring the third year of the tax cut?

Mr. **VOLCKER**. What I think I said consistently is that I would welcome and urge further cuts in the deficit, preferably on the spending side. If you can't do it on the spending side, do it on the tax side, but preferably cuts would come on the spending side.

Senator **Sasser**. One final question, Mr. Chairman. We have had a lot of discussion here today about problems that are being occasioned by the economy and economic policy that we are presently pursuing, and some of my colleagues, I suspect myself included, appear to be somewhat emotional on some of these issues. But we are back home every weekend talking to the people and seeing what the consequences of this policy have amounted to.

And, it is pretty sad to see—I referred a moment ago to the problems of the small business community—we have got over 85,000 farmers in my State. Most of them are small farmers. Most of them are family farmers. They are in a situation now where the interest costs for most of them—the interest costs are exceeding their actual farm profits. The Department of Agriculture is telling us that their Farmers Home Administration loans—and most of them have borrowed money from Farmers Home Administration—they are telling us that their delinquency rates are between one-third and 50 percent.

RASH OF FARM FORECLOSURES

Now, we are on the verge, Mr. Chairman, of a rash of farm foreclosures in this country like we haven't seen since 1931 and 1932. And this is particularly sad to see because when these farms go under it is a whole family generally losing everything they have got, everything they have worked for for a long period of time.

Now, can't the Federal Reserve Board give these people some relief? Why can't we ease up on the reserve requirements of those banks lending to the agricultural sector, who have a large part of their lending in the agricultural sector?

This is nothing new. Even Arthur Burns did this, and nobody ever accused Dr. Burns of being a Santa Claus. He did it in the 1970's, early 1970's, in response, as I recall, to very serious problems then.

Why can't we have a dual rate of interest perhaps for these interest-sensitive sectors of our economy like farmers, like small business people? Maybe we could wring the inflation out of our economy with our monetary policy and at the same time not destroy these people who are so vulnerable, have no protection really against this type of monetary policy. What is wrong with that?

Mr. **Volcker**. I have a great deal of sympathy for the human problems that you describe. I go home occasionally, too. I don't recall the particular incident that you are referring to, some special policy we had in 1980 where we provided some special assistance to agricultural banks.

INVESTORS SITTING ON SHORT-TERM MONEY

I think if you analyze the situation now you will find the typical bank in agricultural areas is quite liquid. The problem is not that those banks don't have money. The problem is, in many cases, they would prefer to lend it at the high interest rates that they can get in the Federal funds market or other markets rather than lending it to the farmer for a period of time at low interest rates.

You come back to the interest rate problem and, particularly, the willingness to lend for a long period of time at low interest rates.

This drives me back to the basic problem that we are dealing with: How do you give that banker—or whoever is lending the banker money—the confidence to be willing to commit money for a long period of time at a low interest rate?

You know, you are not going to do it by reducing his reserve requirement so he has a little more liquidity than he has now. Why isn't he going to take that money and send it where he is sending it now rather than lend it to that farmer at a low interest rate?

The underlying problem is how can we create conditions in which confidence returns, particularly in the long-term market? A number of you today have emphasized the fact many investors are sitting on a lot of short-term money. How can we encourage them to lengthen their maturities, extend that credit at lower rates of interest for a long period of time?

I think you come back to this question of confidence and all that bears upon it in terms of the inflation outlook, the interest rate outlook, the budgetary situation, and all the rest. It goes back and bears on our policy to the extent that there is some confidence that the Federal Reserve itself is going to continue to keep inflation under control. If you don't have that kind of confidence that somebody is going to do it, that the value of the currency is going to be maintained, you are not going to have a climate in which lenders will want to lend for a period of time to the very people you are talking about or to the big companies or to anybody else.

That is what we have to fight to get in the interests of those very people that you and I are concerned about.

Senator **SASSER**. The problem we have got, Mr. Chairman, is those very people that I am concerned about and which you profess to be concerned about aren't going to be around economically by the time this policy runs its full course. The problem is that the overwhelming majority of them are not going to be able to last out this year, or certainly not through the spring, at least in the agricultural sector of the economy in my State.

That is the problem. That is their short-term problem.

Mr. **VOLCKER**. I hope and believe that is not true in terms of the magnitude of the problem, but the problem is very serious. I don't contest that at all.

Senator **SASSER**. Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you, Senator Sasser. Mr. Chairman, we appreciate your patience today; and, if you haven't proven anything else to this committee, you have proven you have great sitting power to stay for 3 hours and 10 minutes. We thank you very much, and the committee is adjourned.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[Additional material received for the record follows:]

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, D.C., August 17, 1982.

Hon. HARRISON SCHMITT,
U.S. Senate,
Washington, D.C.

DEAR SENATOR SCHMITT: Thank you for your letter of July 21. I am pleased to furnish you with responses to the written questions you submitted in connection with the hearing held on July 20. I have also furnished a copy of these responses to the Senate Banking Committee for inclusion in the record of the hearing.

Best Available Copy

Please let me know if I can be of further assistance.

Sincerely,

Paul A. Volcker, *Chairman.*

Enclosures.

Question 1. It has been suggested that the demand for credit for corporate mergers and acquisitions has helped to keep interest rates high. Would you comment on this please?

Answer. I don't think the demands for credit to finance corporate mergers and acquisitions have been a significant factor behind the high level of interest rates. In general, such transactions involve simply a transfer of ownership of shares in an existing enterprise. They buyer borrows to pay the shareholders of the firm being absorbed, in the process creating a demand for funds. However, the shareholders then must do something with the funds they've received, and the reinvestment of those monies provides funds to the market. In economic terminology, such a transaction gives rise to no net demand for savings—that is, there is no diversion of current income for consumption to investment. Although "imperfections" in the capital markets might lead to some frictional or transitory impacts on interest rates and credit availability for other borrowers, the overall effect of merger activity should not be substantial and does not appear to have been.

I might note that the publicity attending some of the merger transactions has left people with a somewhat distorted idea of the quantitative dimensions of the credit flows involved. Figures on the huge lines of credit arranged, sometimes involving competitive efforts by more than one firm to acquire another, have greatly overstated the actual amounts of credit ultimately taken down. Those sums have not bulked large at all in the bank loan totals, for example.

Question 2. There has been recent discussion of the possibility of a wave of unexpected major corporate failures occurring sometime late this year—or next. What is your view with regard to this possibility?

Answer. I'm sure you can appreciate the difficulty of forecasting the unexpected. The fact is that we have seen to date some sizable corporate failures. I don't think these were in all respects "unexpected," for securities analysts and others who have tracked developments in individual firms closely knew that there were significant problems brewing for some time. Clearly, there are a good many firms today experiencing considerable stress—struggling with various combinations of weak sales, depressed cash flows, and large interest burdens. I would hope that the upturn in economic activity we are anticipating and the current trend of moderation in interest rates will result in improved profitability and an alleviation of these financial strains.

One cannot rule out the possibility of some additional significant business failures, however, either among firms now widely recognized as being in serious trouble or among other firms whose difficulties may not yet have attracted widespread attention. I certainly do not take this matter lightly, and people in the Federal Reserve are constantly monitoring developments so that if any failures do occur we are able to assess the situation quickly and take action when necessary to prevent any generalized liquidity probems that might lead to broad economic dislocation. We are mindful of the System's fundamental mission as the lender of last resort, and our commitment to maintaining adequate liquidity in the economy helps to lower the risk of a damaging "wave" of large business failures.

Question 3. As you know, the Japanese deficit as a percentage of GNP is substantially larger than that of the United States. Yet their interest rates are lower. It is generally suggested that the Japanese rate of personal saving—close to 21 percent of disposable income—allows the Japanese to finance their debt at lower rates. The Japanese Government permits up to $52,000 in principal to generate tax free income. But in this country we have tended to look at only the demand for credit—particularly that of government—ignoring our national rate of saving as a component in the solution to our interest rate problem. In your opinion, would the Congress be well advised to consider expanding the incentive to save as a means of getting interest rates down and keeping them there?

More specifically, should the Congress attempt to create specific incentives designed to raise our nation's rate of savings to the 8 percent level which prevailed in the early 1970's?

Answer. The tax reduction passed last year contained in it several measures that work to enhance the incentives to save rather than consume. The lowering of marginal tax rates for individuals and the accelerated depreciation provisions certainly stand out in this regard. I think these broad measures are likely to be more effective in raising the overall proportion of resources devoted to saving and investment than are many specific savings incentives, which frequently can be expected to do little more than shift the form of savings and which tend to be cost-ineffective from the standpoint of lost tax revenues.

The matter of tax revenues raises an important point—namely, that large government deficits work counter to a desire to lower interest rates or to enhance private capital formation. Federal deficits absorb private savings, so that movement toward budgetary balance is an integral part of a meaningful effort to improve the financial climate.

One final note: it probably is not wise to focus on any particular magic number of a goal for saving. The optimal level of saving for an economy is not readily determined, and it may be most important simply to create the kind of general economic environment and tax climate that does not tilt the scale of incentives against saving. Moreover, it is really not appropriate to focus solely on the personal saving rate. Households are important contributors to the pool of savings, but so too are businesses, the government potentially, and foreigners. This is just one of many reasons why international comparisons of saving behavior must be performed with a considerable degree of caution; financial structures differ considerably from country to country.

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1982

WEDNESDAY, JULY 21, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m. in room 5302 of the Dirksen Senate Office Building; Senator Jake Garn, chairman of the committee, presiding.

Present: Senators Garn, Riegle, Sarbanes and Dixon.

The CHAIRMAN. The hearing will come to order.

We continue today with the second day of hearings on the conduct of monetary policy. We do not have our first witness here yet; however, in a year and a half, this committee has started on time. It will continue to start on time, even when we don't have witnesses here. The chairman will be on time.

So now that we have started and kept the record perfect, we will hold until Mr. Weidenbaum arrives.

[Brief recess.]

The CHAIRMAN. Mr. Weidenbaum, the committee has already started, although I was the only one here. I understand that you were in the building on time.

Mr. WEIDENBAUM. Yes, sir.

The CHAIRMAN. We'll be happy to hear your testimony at this time.

STATEMENT OF MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. WEIDENBAUM. I have prepared a fairly technical presentation this morning. Before I present it, I would like to highlight a few key points.

First, the Federal Reserve's monetary policy has been the key to the successful unwinding of inflation that we have witnessed during the past year and a half.

Second, the administration and the Fed have been, and continue to be, on the same wavelength during this entire period; that is, we consistently agree that slowing down what had been an unsustainably rapid growth in the money supply is basic to achieving a less inflationary economy.

And three, there are many technical problems that arise in the conduct of monetary policy. My prepared testimony deals mainly with those technical problems, but in the context that I have just sketched out. That is, I present the following analysis from the viewpoint of strong and continuing support for the efforts of the Federal Reserve in dealing with the serious problem of curtailing inflation in a careful and responsible way.

I am pleased, of course, to appear before your committee to discuss the current conduct and performance of monetary policy.

[The complete statement follows:]

Statement

of
Murray L. Weidenbaum, Chairman
Council of Economic Advisers

Mr. Chairman and Members of the Committee:

I am pleased to appear before your Committee to discuss the current conduct and performance of monetary policy. During this period of painfully high interest rates, it is appropriate that we intensively scrutinize both the objectives and the implementation of the Federal Reserve's monetary targets and its monetary control procedures.

Let me begin by underscoring the point that the Administration and the Federal Reserve agree on the basic dimensions of monetary policy. Both the Administration and the Fed believe that a gradual reduction in the growth of the money supply is the best policy for achieving price stability. This reduction is best accomplished when the Fed enjoys independence from the routine pressures of the political process, and understands unequivocally that its primary mandate is to attain and maintain price stability.

Selecting a Definition of Money

The Federal Reserve can eliminate inflation most rapidly and least painfully if it concentrates on announcing an appropriate target for money growth and then achieving that growth as closely as possible. A key decision in this process is choosing the specific definition of money for which growth is to be targeted.

Selecting a particular definition of money to target is not a simple task. As is true of almost all economic data, the proper statistical definition of money is at times less clear than we would like. In recent years new types of financial assets have been created, such as money market mutual funds, and the characteristics and usage of old assets have changed. For example, with the invention of the NOW account in 1971, an asset appearing in our statistics as a savings account became checkable. The evolutionary character of our monetary system means that the definition of money shall not remain static for the purposes of monetary policy.

The Federal Reserve should and does revise its definitions of money as changes in our monetary system occur. It did this most recently in 1980 when it began to include NOW accounts along with demand deposits and currency in its definition of M-1. Table 1 shows the changing composition of M-1 over the last several years. While currency has remained a stable 27 to 28 percent of the money supply, demand deposits have declined from 69 percent of M-1 at the beginning of 1979 to 53 percent in early 1982. Meanwhile, NOW accounts and other checkable deposits have risen rapidly from 4 percent to almost 20 percent during the same period.

Economic theory suggests and the data confirm a predictable relationship between the growth rate of money and the future growth rate of total spending and income in the economy. This relationship is remarkably stable when examined over periods long enough to average out

Table 1

COMPOSITION OF M1
(In Percent)

Year and Quarter	Currency	Demand Deposits	Other Checkable Deposits
1979:1	27.1	68.9	4.1
1979:2	27.0	68.3	4.7
1979:3	27.0	67.9	5.1
1979:4	27.3	67.5	5.2
1980:1	27.4	67.0	5.6
1980:2	28.2	65.8	6.0
1980:3	27.9	65.4	6.6
1980:4	27.8	64.9	7.3
1981:1	27.8	58.8	13.4
1981:2	27.7	55.9	16.4
1981:3	28.0	54.8	17.1
1981:4	27.9	54.0	18.0
1982:1	27.8	52.6	19.6

Source: Board of Governors of the Federal System

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transitory disturbances and statistical noise. The relationship between money growth and nominal GNP does not necessarily hold closely on a quarter-to-quarter basis, however, since money growth tends to affect income only after a lag that tends to be somewhat irregular and unpredictable. Of the alternative definitions of money, the growth of M-1 demonstrates the highest statistical correlation with the growth of nominal income.

It is sometimes suggested, though, that more broadly defined measures of money may show a stronger relationship with spending and income than M-1. If so, they would provide a more appropriate focus for monetary policy. Several more comprehensive definitions of money are available. For example, M-2 includes various liquid assets, such as savings accounts and money market funds, that are relatively close substitutes for currency and checking accounts. However, statistical tests comparing M-1 and M-2 suggest that changes in M-1 provide a more reliable indicator of changes in national income. A four-quarter moving average of M-1 growth captures almost all of the changes of a four-quarter moving average of nominal GNP growth; a moving average of M-2 does not perform as well. Given this evidence, I believe that it is best to continue to place primary emphasis on controlling the rate of growth of M-1, while watching the other monetary measures for signs of unexpected developments.

Setting and Achieving Monetary Growth Targets

Since 1975 the Federal Reserve has announced annual targets for monetary growth. These targets are expressed in terms of a range, with two to three percentage points between the high and the low ends. For 1982, the Fed's target for M-1 growth is between 2-1/2 and 5-1/2 percent. Over the last six years the Fed has frequently failed to hold M-1 within its target ranges. In 1981 and the first few months of 1982 the Fed first undershot and then significantly overshot its targets. Published minutes of Federal Open Market Committee meeting show that the Fed's trading desk in New York was often given instructions to aim M-1 growth in a direction substantially away from the mid-point of the annual target range. While the Fed admittedly faces technical problems in pinpointing month-to-month monetary growth precisely, it is capable of exercising greater year-to-year control than it has achieved to date.

Frequently, the Fed has stated that its primary reason for adhering only loosely to it M-1 targets in previous years was its desire to achieve other objectives as well. Before October 1979 great weight was given to short-run stability in the federal funds rate, and the Fed was unwilling to adjust the federal funds rate rapidly enough to hit the announced monetary targets. In the second half of last year considerable weight was given to the target range for M-2. At other times, other variables have assumed importance.

Although the Fed's desire to achieve simultaneous targets for numerous variables is understandable, I believe it is generally an error to allow those objectives to sidetrack the goal of meeting M-1 targets. Nominal income growth has continued to demonstrate a more stable relationship to the growth of M-1 than to any of the other monetary aggregates. This is true despite the proliferation of financial innovations and new forms of checking accounts. In the absence of compelling evidence that the relationships between M-1 and other economic variables are changing, the M-1 target range provides sufficient leeway to adjust M-1 growth up or down to reflect short run developments such as higher or lower than expected growth in M-2.

The rationale most frequently cited for the Fed missing its M-1 targets over the last several years is that the growth of velocity is changing. The velocity of money, or its rate of turnover, can in fact complicate the relationship between money and income. Fluctuations in the velocity of money affect national income in the same manner as do fluctuations in the supply of money.

Fortunately for policy makers, the underlying growth of M-1 velocity has proven remarkably constant and predictable for the last several decades. Velocity growth has averaged about 2 percent a year since the begining of 1981, a figure which is close to the average growth of 3 percent from 1959 to 1981. Quarterly velocity changes have varied widely throughout the recent past, and particularly in the last 18 months, as a partial consequence of volatile money growth. But the observed path of velocity growth becomes far smoother as the measured intervals are lengthened. Most movements from a long-run 3 percent growth trend disappear when the growth rate of M-1 velocity is measured year-to-year as shown in Figure 1.

Admittedly, there is no inherent reason why the growth rate of M-1 velocity should remain constant indefinitely. There are presently forces at work which may affect velocity growth trends, although in different directions. On the one hand, the increasing popularity of money market funds, which are included in M-2, have probably tended to increase the growth of M-1 velocity. On the other hand, the decline of inflation and the spread of interest-bearing transactions accounts have probably tended to decrease the growth of M-1 velocity. At present, there is no indication that one of these two forces is dominating the other and thus systematically shifting the trend of M-1 velocity growth.

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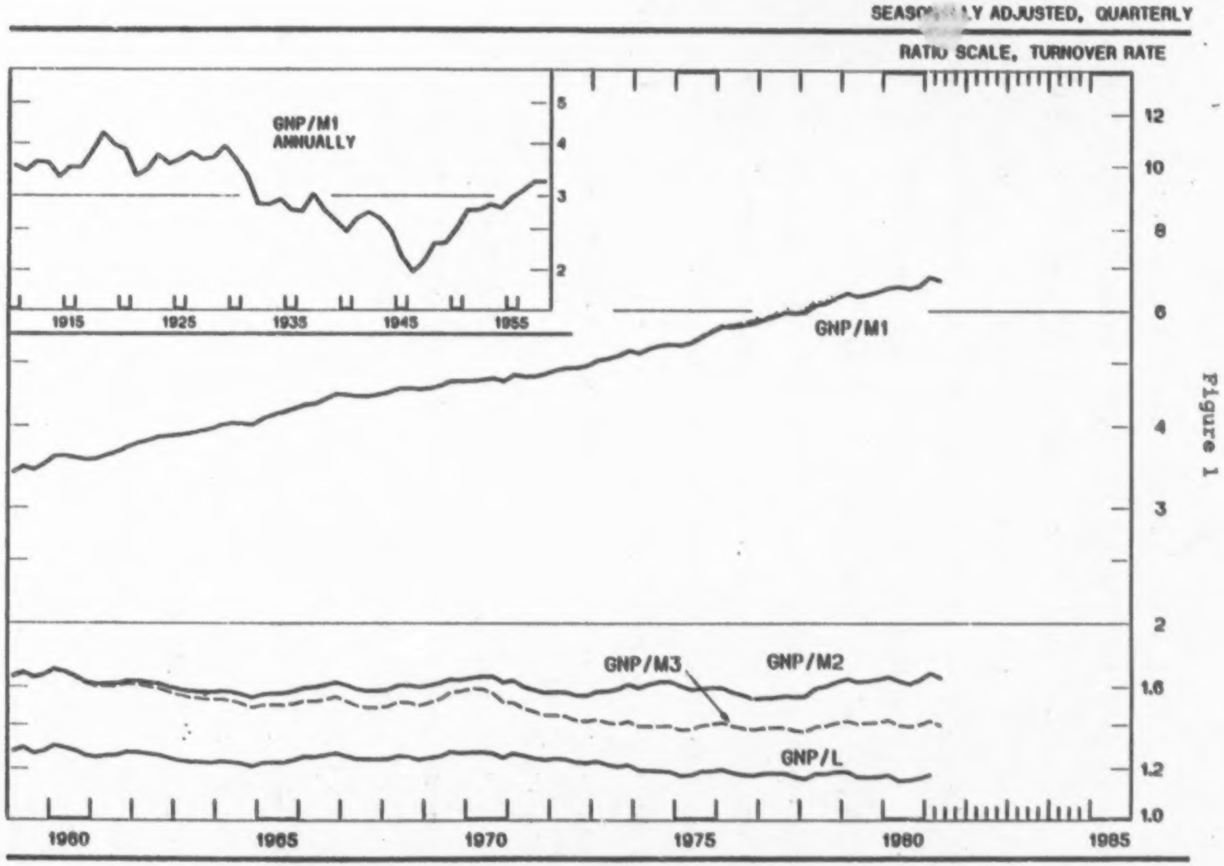
INCOME VELOCITY OF MONEY



Source: Board of Governors of the Federal Reserve System

Figure 1

The relative predictability of velocity is convenient in that it allows the Federal Reserve to rely on a fairly stable relationship between the growth of money and the growth of nominal income. Unless and until a long-term shift in the money velocity trend becomes apparent, the Federal Reserve should follow a path of stable M-1 growth. As recovery proceeds, announced reductions in both targeted and realized money growth are essential to minimizing the costs of permanently eliminating inflation. Unannounced and unanticipated reductions in money growth will depress output and employment until wages and prices adjust to the lower level of nominal income consistent with lower money growth. Conversely, sudden and unexpected increases in money growth will rekindle fears that the Fed is not truly committed to reducing inflation.

It is clear that inflationary expectations are adjusted only as the actual course of monetary policy proves consistent with policy objectives. The credibility of the Fed, like the credibility of anyone else, is enhanced when it achieves what it says it is planning to achieve. For the Federal Reserve, this requires establishing money growth targets which are consistent with a sustained decrease in the rate of inflation, and then adhering to those targets. The more success the Fed enjoys in meeting its targets, the less time it will take before the public is convinced of the Fed's credibility, and the more rapidly wages and prices will adjust to noninflationary monetary policies.

Variability of Money Growth

So far I have emphasized the need for the Federal Reserve to concentrate on M-1 as its principal monetary target variable, and to meet its annual targets for growth in M-1. I would also like to discuss the importance of the Fed's achieving smooth monetary growth within a given year.

Due to uncertainty about the Fed's future actions, public expectations about future rates of monetary growth, and hence future inflation, have become more volatile in recent years as current money growth has become more volatile. This is understandable, since it is difficult to determine whether a deviation of money growth from a targeted growth path represents a temporary discrepancy or a fundamental change in the growth trend of money.

Statistical tests applied to past data suggest that the best guide to future monetary growth levels is primarily the growth rate for the most recent period. Given this historical regularity, the market may not necessarily believe that current Federal Reserve policy does indeed involve a distinct break with its previous policies, and that the Fed will in fact correct current deviations from targeted growth rates at some future point in time. Consequently, when money growth strays above the target range, even temporarily, long term interest rates rise as both higher money growth and inflation are expected in the future.

Thus, at least in the current monetary environment, unanticipated changes in short-run money growth tend to destabilize interest rates across the maturity spectrum, and not just short rates. If the Fed could achieve more precise control over money growth, that would lessen capital market fears that departures of money growth from target may indicate a beginning of a new trend. Also, fluctuations in longer-term interest rates would prove much smaller.

The justification given most frequently for temporary shifts in money growth by the Fed is that unstable demand for money requires fluctuations in the money supply. Without shifts in money growth, it is hypothesized, short-term changes in the demand for money would result in large and sudden swings in interest rates. This argument is essentially identical to the assertion that short-term variability in velocity justifies shifts in money growth.

The problem with attempting to control the money supply in accord with perceived short-term shifts in money demand is that, while achievable in theory, it proves counterproductive in practice. It is usually difficult to determine at any point in time whether an apparent shift in the demand for money is due to a change in the demand for money relative to the pace of economic activity, or due to a change in the level of economic activity itself.

If economic activity is decreasing, lowering money growth will only serve to worsen an economic slowdown. Conversely, raising money growth when economic activity is picking up will aggravate the inflationary consequences of rapid economic expansion. Past attempts by the Federal Reserve to offset hypothesized shifts in money demand and to control interest rates have led to variations in money growth which have exacerbated previous business cycles. An excessive focus on shifts in the short-term demand for money and their effects on interest rates have caused both money growth and inflation to accelerate. This was certainly true in the years between 1965 and 1980.

Even if temporary shifts in the demand for money were easily identified, which they are not, the Fed would be well advised to ignore them. We can infer from velocity growth data -- which in part reflect shifts in money demand -- that deviations from trend tend to reverse themselves within a year. Insofar as variations in money growth are used to smooth interest rate paths, only rates on debt instruments of very short maturities -- probably less than six months -- would be significantly affected.

Moreover, in the current environment, variability in interest rates on long-term maturities, such as mortgage rates and various bond rates, is actually likely to be increased rather than decreased, as changes in money growth lead to changes in the market's forecast of future inflation. In short, the gains from offsetting temporary disturbances in money demand are small, transitory, and problematical. The costs in terms of destabilizing expectations and higher long-term interest rates are significant and clear.

Economists who are skeptical of the importance of lowering volatility point out that a number of countries which enjoy relatively low inflation rates, such as Germany and Switzerland, have more variable monetary growth than the United States. This observation is interesting, but it is also misleading. The United States has experienced increasing monetary growth on average over the last 15 years, and is trying to reverse that trend. West Germany has experienced nearly constant money growth, on average, since 1960, and in Switzerland money growth has actually declined. As a consequence of their prudent monetary policies in the past, the German and Swiss central banks enjoy the confidence of the public. They can afford to allow considerable month-to-month variability in money growth without generating high and volatile inflationary expectations.

In contrast, the United States Government -- no matter how sincere the anti-inflationary efforts of the Federal Reserve, the Administration, and the Congress -- must convince people that its behavior in the future will differ significantly from the past. The legacy of previous monetary expansion seriously constrains our monetary authorities, who face the unenviable task of establishing the degree of credibility enjoyed by their German and Swiss counterparts.

Improved Monetary Control

The major departures of money growth from targeted trends on a quarter-to-quarter basis that we have seen in recent years are by no means inevitable. The Federal Reserve is technically capable of achieving fairly smooth M-1 growth, measured over periods of several months rather than week to week. According to a 1981 Federal Reserve study on monetary control procedures, the growth rate of M-1 from quarter to quarter need not deviate on average more than plus or minus one percentage point from target, at annualized rates. Attaining this degree of precision would result in a substantial improvement over current performance.

I am pleased to note that changes in Federal Reserve procedures are occurring which should improve the controllability of money growth in the future. The recent

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decision of the Federal Reserve to adopt contemporaneous reserve accounting should allow the Fed's open market operations to have a more immediate effect on total bank reserves and M-1. Also, the phasing in of more uniform reserve requirements for different forms of bank accounts, as required by the Monetary Control Act of 1980, should help to reduce random fluctuations in money growth.

Improved control of the money supply remains within the Federal Reserve's grasp. A reduction in the fluctuations in money growth might result in more variable interest rates on loans of very short maturity. But the change would help to stabilize the longer-term interest rates that matter most for investment decisions and general economic performance.

Conclusion

We have learned over the last several years that reducing inflation, while essential for a strong economy, entails large but temporary costs in the form of lower employment and dampened economic activity. The challenge for the Federal Reserve, as well as for the Administration and the Congress, is to achieve price stability while minimizing the toll that must be paid for it. Monetary policy has played a critical role in achieving the substantial reduction in inflation that we have experienced over the last year-and-a-half. The Federal Reserve, by adhering to the current direction of its policies in a predictable and reliable fashion, can play an essential part in demonstrating that stable prices and healthy economic growth are both compatible and mutually reinforcing.

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Mr. **Weidenbaum**. Thank you, Mr. Chairman, for your forebearance.

The **Chairman**. Thank you, Mr. Weidenbaum. Yesterday we had a very long session with Chairman Volcker and as I sat and listened to not only the testimony, but the questions from both Republicans and Democrats, I made the comment, Murray, that nothing much seemed to change. Some of the roles reversed.

Yesterday, the minority was valiantly trying to make certain what you've said in your testimony, that, in general, the administration agrees with Fed policy. And I can remember when the Chairman came here and we Republicans were trying to make sure that we, for political reasons, that Carter and Chairman Volcker were in lock-step going down.

And I listened to all of these figures and all of this detailed economic philosophy and, I don't know, I'm to the point where I wonder if it even means anything, because there was no disagreement among members of this panel yesterday, Republican or Democrat, about the problems of high interest rates and high unemployment and the crisis that this economy is in.

BUDGET PREDICTIONS CONSTANTLY UNDERESTIMATED

But after 8 years of sitting on this panel and listening to economists, and you know how I feel about you personally—so I don't mean this personally at all—what does it all mean? Everybody's wrong. We come in and we hear all these figures and we have all of these predictions, and they're meaningless because they never come true. Do our economists have crystal balls? I mean, it's just absolutely amazing.

In 8 years here I've seen administrations—and this one is doing what every other one has done—making projections that simply don't fit into the world of reality. You would think we would learn from hindsight because no budget presentation by a President, an administration, either Republican or Democrat, or from Congress, or from the Congressional Budget Office, from anybody, since I have been here, has come anywhere close to what actually happened. And they've all been underestimates, without exception. Every single time every year.

Now do we ever get smart? Does anybody get smart? Economists? Republicans? Democrats? Presidents?

People are out there suffering, Murray. And we hold these hearings and we talk about these things, and the reason I sit here and sometimes don't even particularly listen, is because 6 months from now, nobody's going to be right. They never have been before.

I'm just asking a very practical question: Isn't it possible for people to have a little commonsense and say, nobody's predictions have been right, at least while I've been in politics. Why don't we try and be a little realistic and look at past history for making projections? But I don't think that anybody has a right to criticize anybody else and say, this administration's estimates are off. I can go through what Congress has done in the last couple of years. We haven't come close.

Nobody—Alice Rivlin isn't close to hers. She's supposed to be independent of anybody and just advise. I haven't found a set of figures on this economy or any budget year that have been anywhere close to the reality of what has actually taken place.

Mr. **Weidenbaum**. Mr. Chairman, the short answer to your point is, yes. As you often do, you've hit the nail on the head. The record for specific monthly and quarterly forecasts of the economics profession is not very good.

The **Chairman**. How about yearly?

Mr. **Weidenbaum**. Much better.

The **Chairman**. Not much.

Mr. **Weidenbaum**. Over the years, the standard private forecasts, as reported in blue chip indicators, have been quite close to the mark. I don't want to give them a commercial, but let's just say a wrapup of what 30 or 40 major private forecasters are saying.

In our case, in February 1981, we forecasted the year. We said that real growth would be 1.1. It turned out to be 2 percent. We said that inflation would be, the CPI would be 11.1. It was a shade under that.

Frankly, I think as general guides, that was useful. But there's something more basic. And that's why I'm so pleased that this is a hearing focusing on monetary policy. I think you don't need pinpoint accuracy in forecasting.

The **Chairman**. Murray, what I'm talking about has nothing to do with pinpoint. The administration—well, let's go back to all of them, the most current one—remember the $45 billion deficit?

Mr. **Weidenbaum**. Now I don't take credit for——

The **Chairman**. Remember some of us were sitting down there and saying, hey, hey, hey, and you believe in the tooth fairy, too. But they persisted. And I sat and served in a Congress that in June of 1980 passed the first concurrent budget resolution; I mean, not estimates, passed it and said, we're going to have a $200 million surplus. And by August, it was a $27 billion deficit. By the time we got to January and February, it was a $70 billion deficit.

I mean, we're not missing by a little bit. These aren't fine. I mean, they're just gross. It has nothing to do with partisan politics. If you're the out-party, you criticize; if you're the in, it's all right and you try and cover it up. But it knows no party bounds, no political philosophy. Just the grossest of errors on the budget over and over and over again. Who's kidding who? Those people are out there suffering. They don't even know what M_1 is. They could care less. They know they're unemployed. They know they're paying 16½, 17 percent interest, and we're playing games with numbers that are always wrong.

Mr. **Weidenbaum**. There's something basic here, Mr. Chairman, and that is the kind of monetary policy that we have developed not only doesn't depend on forecasts, but I think, objectively, has worked. Let me give you just three dates, and they're not chosen at random, frankly: January 1977; January 1981, and today.

January 1977, the prime interest rate was 7 percent. January, 1981, the prime was 21 percent. Today, it's 16 percent. And I'm not saying that from a partisan basis because I'm not going to relate that to who was in office, but what was the policy during that period.

During the more recent period, the policy has been to slow down the growth of the money supply. During the previous period, the policies were quite different than that. I think, visibly, embarking on the policy of monetary restraint has succeeded, more slowly than you and I would like it, of course, and more slowly than we expected, frankly. But it has succeeded in bringing down interest rates. And it didn't require an economic forecast; it required the adoption of the appropriate monetary policy, which, of course, is the whole thrust of my statement.

And I maintain that the basic reason not only that we've gotten this progress on interest rates, but the very substantial progress on inflation, is the monetary policy that has been followed in the past year and a half.

The **CHAIRMAN**. Well, relatively speaking, the reduction from 21½ to 16½ percent interest is good, although they used to put people in jail for charging 16 percent interest. It's known as usury. I never thought I would live long enough to pray every night for a 12-percent prime and think people were giving money away at 12.

Well, my point was simply one of frustration and without regard to political party or economic philosophy of various economists. I think our track record on forecasting and trying to manage the monetary and fiscal policy of this country is so poor, that I wonder about the science of economics, the practicalities of at least not being able to learn from past experience.

Now I admit, some of the estimates that I'm talking about lie solely in the political field, in administrations and in this Congress, who, for political purposes, I guess, exaggerate one way or another.

Mr. **WEIDENBAUM**. Well, a wiser man than I has said that economic forecasting is neither an art, nor a science; it's a hazard and one not covered by OSHA.

The **CHAIRMAN**. Senator Riegle?

SERIOUS ECONOMIC CONDITIONS

Senator **RIEGLE**. Chairman Weidenbaum, we did have a long session yesterday with Chairman Volcker. And I must tell you, both from the vantage point of my State of Michigan, which is the hardest hit State by the recession and the economic conditions, and all across the country, all 50 States, that we have a desperately serious economic situation on our hands.

All the major indicators right now bear that out: Unemployment—we've got 10½ million people out of work across the country, and at least another million and a half that aren't counted in the statistics any more because they've been unemployed for so long, as well as estimates of maybe another 5 million that are substantially underemployed. We've got business failures right now running at an all-time record rate since the Depression. We're losing 550 a week. We're losing one every 20 minutes around the clock, 7 days a week, and many of them good, solid businesses, well-managed businesses. They're being ground down by the high interest rates and the general conditions of recession.

We've got financial institutions failing. We've got virtually every S. & L. in the country in trouble, and many in very desperate serious trouble. We've got the auto industry below 50 percent of capacity, the steel industry running at about 40 percent of capacity. We've got a depression in the housing and construction industry.

We've got agriculture in deep trouble in many areas of the country. We have a bona-fide interest rate crisis. And we can talk about the half-point drop in the discount rate and the fact that the prime has dropped to 16 percent. But I have to agree with the Chairman: 16 percent is really no consolation in terms of the problem we face today, and most small businesses can't borrow at 16 percent. They're borrowing at 2, 3 points above prime, if they can get the money. So we've got an urgent situation on our hands.

In this week's issue of U.S. News & World Report, it says as follows on page 11. And they seem to have a pretty good reading on the thinking in the White House. They lead with this statement:

> The President will stand pat on economic policy for the rest of the year. Reagan won't be turned around, even though the oft touted "just around the corner" recovery is looking more and more elusive. Political realism is the key. There's not much the President can do between now and the election time to give the ailing economy a quick fix. The White House game plan is to tough it out, insist Reaganomics will work, and hope that things perk up soon to prevent heavy losses in Congress this fall. The last thing that Reagan wants is to be accused of "Carterism," being wishy-washy on major issues. Reagan's advisers argue that this steadfastness is a virtue; shifting gears would send bad signals.

And it goes on in that vein.

I hope that's wrong.

Mr. WEIDENBAUM. It is. I'd be glad to explain.

The CHAIRMAN. I hope you're prepared not to stand pat on economic policy. You know, you're a person who brought a reputation into this job because of your fine service over many years as an economist, as a professor, as a person of stature and standing in your own right. And I find it hard to imagine that we can let the conditions that go on that we're seeing today without someone like you blowing the whistle on this and saying that the policy mix needs to change.

The deficit next year, I believe, as a member of the Budget Committee, will exceed $130 billion. I think we'll be lucky to hit $130 billion because spending is out of control. Defense spending has gone wild. There are so many sacred cows in the budget that haven't been touched that you could put a list from here to the end of the room.

I think the deficits in the out-years, 1984 and 1985, will be in the $200 and possibly even as high as $300 billion range. And let me tell you something. As I talk to bankers across the country, people on Wall Street, heads of major corporations—that's what they believe. That's what their economists are telling them. That's the basis upon which they're making their plans.

And capital investment plans right now, as you know, have fallen literally to a record low. We are not seeing the supply-side spurt that was supposed to take place at this time.

So in light of this, my question to you is this. The President seems to be disconnected from these realities. What he says in his public statements does not show a recognition of the seriousness of this problem. I don't know what his thinking is, but I find it inconceivable that you would not see these problems. I just have too much confidence in your own ability, in your own professional strength to see that we have an urgent situation on our hands, and I would want to believe that you were fighting in every way to try to change it, to change the policy mix, to bring the deficits down, to fight to get a lowering of interest rates now before we see a broader collapse in the economy.

So my question is: Are you making that kind of an effort? What is going to happen? Can we have any hope that we'll see a change in policy between now and the end of the year? Or are we just going to be in this state of paralysis on economic policy while more and more damage and hardship and suffering in this country takes place?

DIFFICULT TIMES ARE BEHIND US

Mr. **Weidenbaum**. I'd like to answer that this way. In the second quarter of 1982, real economic growth equalled 1.7 percent. That is the first positive sign of an expanding economy that we've had since the middle of last year. So I think it is quite clear that the worst of the difficult times that you so accurately described are behind us.

I can assure you that the President not only is intimately aware of the economic situation. I briefed him as recently as yesterday afternoon in the Oval Office. But he cares deeply and is convinced that his program, as fully carried out, will restore the health of the American economy, with high levels of employment and economic growth and low inflation.

Very frankly, those budget deficits that you referred to are deeply worrisome. They are much, much larger than I would like to see. I have said repeatedly, in public, as well as in private, for months now, that I think we need to see the budget deficit decline from its peak in this recession year of fiscal 1982. It's going to take a lot more budget cutting up on this side of Pennsylvania Avenue to achieve that objective.

I think there are too many sacred cows in the Federal budget. I don't limit them to any one department. Specifically, I'd start, in alphabetical order, appropriately enough, with the Agriculture Department. There are sacred cows there, but I would include every department, military and civilian, in the further budget restraint that is necessary in order to get those deficits down because I do believe that the high interest rates—and again, I've been saying that consistently—the high interest rates are the key barrier to a strong recovery.

TIME RUNNING OUT

Senator **Riegle**. Let me make a suggestion to you because I'm afraid what's happening here is we're running out of time. We're running out of time both in terms of the economy and the structural strength and damage that's being done, and also, we're running out of time in this session of Congress. We have about 45 working days left between now and an October 2 adjournment.

The **Chairman**. Forty-four. We had 45 yesterday.

Senator **Riegle**. Forty-four days. [Laughter.]

Mr. **Weidenbaum**. Republicans are always pretty sharp on numbers. [Laughter.]

Senator **Riegle**. Howard Baker has announced that we will adjourn, his target date is October 2. So that gives us very little time; the window is closing on this session of Congress.

Once the Congress goes out of session, there's also been an indication by the leadership that they would prefer not to see a postelection session. So who knows whether there will be one or whether anything can be accomplished. But then the new Congress will not come in until late in January and with the startup time in getting organized, setting up new committees in the House and Senate, and so forth, and you've got a situation where the Jefferson, Jackson, the Lincoln day recess is in February—it will be really the first part of the second quarter of next year before the Government as a whole is able to deal with the economic policy problem or with the whole fiscal monetary mix issue.

And so we're about to go into a period where, for about 6, 7 or 8 months, it's going to be very difficult for our Government as a whole to function. Even the President, if he wanted to act unilaterally, with the Credit Control Act just expired—I mean there are limits——

Mr. **Weidenbaum**. Thankfully.

Senator **Riegle**. Well, that may be your view.

Mr. **Weidenbaum**. It is.

Senator **Riegle**. And the time may come when you wish you had those powers. Let's hope now.

In any event, if the President wanted to act unilaterally, he's quite limited and constrained with respect to economic policy initiatives. He would need the Congress, especially if we're going to do something about spending, if we're going to do something about the fiscal side of things.

So in light of that, in light of the jeopardy that the economy is now in and with the window closing on this session of Congress, I'd like to make this suggestion to you. I think it would be very constructive if the President were to decide to take hold of this economic problem in his own hands directly in this form—that he would convene a kind of emergency budget summit meeting and invite the leaders of the Congress from both parties to meet with him, with him running the meeting, maybe at Camp David, some setting such as that. Invite Paul Volcker and the members of the Fed to come to such a meeting. And the meeting might go on for 2 or 3 weeks, for as long as it might take to work out a bipartisan agreement on major budget reductions for 1983, 1984, and 1985. Then we could come back and legislate the program into place so that the financial markets and capital investment decisionmakers across this country could count on it, so that, in turn, we could get a monetary policy response that would substantially reduce interest rates now. Not to 16 percent and with 16, maybe going back to 18 or 20 between now and the end of the year, as Henry Kauffman and some others are predicting may happen, but to give us a certain reduction in interest rate so that we could start to see the economy move and people go back to work.

If we could get just 1 percent of the unemployed people, 1 percentage point of our 9½ percentage points of unemployed people back to work, we could reduce the deficit by $30 billion.

Frankly, I don't see any way that we're going to tackle this problem on the scale that it needs to be tackled unless the President himself were to lead that process directly and invite the rest of the key players on a bipartisan basis to take part in such a piece of work.

There has been no such meeting. The "Gang of 17" that met for weeks and weeks and weeks, the only time that the President or Tip O'Neill, either one, participated was in the last meeting, which was really window dressing after it was clear that the whole process had failed.

We need to start again. Would you be willing to support that idea and present that idea to the President?

RECESSION BOTTOMED OUT

Mr. **Weidenbaum.** I'll be glad to transmit your suggestion, Senator. But it strikes me, very frankly, on the basis of my knowledge of recent American economic history that usually, crash efforts do just that. If they don't crash, they come in far too late, way after the economy has turned. And it strikes me, when I look at the economy, clearly, we have bottomed out of the recession. The economy is beginning to turn up.

I look at a table of interest rates—I'll be glad to submit it for the record—at every maturity, from the Federal funds rate, Treasury bills, prime rate, 3-year money, 30-year bonds, municipal bonds, interest rates across the spectrum are coming down.

In other words——

Senator **Riegle.** What about unemployment?

Mr. **Weidenbaum.** Unemployment has stabilized.

Senator **Riegle.** Isn't it rising? Aren't we likely to see a rise in unemployment?

Mr. **Weidenbaum.** It was 9.5 percent the last 2 months. It sometimes lags behind the upturn in the economy.

Senator **Riegle.** Is it rising or is it staying steady or is it dropping?

Mr. **Weidenbaum.** My point is that the crash efforts don't come onstream promptly enough to deal with today's problems. When they come onstream, they exacerbate——

Senator **Riegle.** The bottom line is that unemployment is rising.

Mr. **Weidenbaum.** If I may. They exacerbate the inflationary pressures during the upturn, which upturn is already——

Senator **Riegle.** How about housing starts? Are they up? How about auto sales?

Mr. **Weidenbaum.** They have hit bottom.

Senator **Riegle.** They hit bottom?

Mr. **Weidenbaum.** If you look at the trend of housing starts, they hit bottom sometime late last fall. They are still at a very low rate and will take a further decline in mortgage rates.

Senator **Riegle.** You must not have seen the article in yesterday's Post, the fact that they had just dropped again. Auto sales just dropped.

Mr. **Weidenbaum.** The monthly decline——

Senator **Riegle.** Bankruptcies are still rising. Unemployment is still rising. You say we're turning up. What are the measures of the fact that we're turning up?

Mr. **Weidenbaum.** The total level of economic activity, after you boil out the inflation, has risen in the last 3 months. Has it risen rapidly? Of course not. Do we expect that it will rise more rapidly in the coming quarters? Yes. The tax cut effect of July 1 is an important incentive for spurring this economy.

But, very frankly, if we learn from the lessons of the past, the stop-and-go policies don't work. You talk about a crisis in interest rates. Frankly, I question that. With the prime rate at 16 percent, what did you call the interest rate situation when the prime rate was 21½ percent in early January 1981? Was it a crisis then?

Senator RIEGLE. You know, in Japan today, the prime rate is 5¾ percent.

Mr. WEIDENBAUM. Yes.

Senator RIEGLE. And they have a lot more of their people at work than we do.

Mr. WEIDENBAUM. And I think if the budget deficits were smaller, if Congress had appropriated less spending over the years, we'd have lower inflation in this country.

Senator RIEGLE. Murray, this administration came in and asked for bigger budget deficits than we've passed, bigger ones. If we passed the budget you brought to us, we would have deficits larger than the ones I'm talking about.

Mr. WEIDENBAUM. I'm not here to defend the budget deficit.

Senator RIEGLE. I mean, that is really, I think, just——

Mr. WEIDENBAUM. I didn't mean to be partisan.

Senator RIEGLE. It isn't a question of being partisan; it's a question of being honest about it. You folks came in here asking for bigger budget deficits than that. That's the fact.

Now you come around with the constitutional amendment on a balanced budget, which somebody has described as a "figleaf"—an entirely accurate characterization. You can't come in here and ask for a budget with deficits that go up to $200 billion and beyond and turn around in the same breath—I'm speaking now of the administration—and say you're for balanced budgets and you're for fiscal restraint.

That's a total contradiction.

Mr. WEIDENBAUM. It's news to me that we've asked for deficits in that category.

Senator RIEGLE. Pardon?

Mr. WEIDENBAUM. It's news to me, frankly; I'm not aware that we've ever asked for estimated deficits in that category.

Senator SARBANES. Would the Senator yield?

Senator RIEGLE. Yes, my time is up.

The CHAIRMAN. In just a moment. It's your time. His time is up and I will turn to you, Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

TRILLION-DOLLAR DEBT

The CHAIRMAN. Let me just make one quick comment, Don, and I don't want to prolong this at all. I don't like the administration's budget request. But you simply can't constantly try to blame it there, either, and ignore the fact that before this President ever came, without regard to previous Presidents, parties, or Congresses, there was a trillion-dollar debt with a carrying cost of over $100 billion, from whoever was here in either party or any President.

Now that simply cannot be ignored. It didn't make any difference who was inaugurated in January 1981. There were certain inherited problems from the past that have driven some very large problems, particularly decisions because people thought in previous administrations that interest rates would come down. They started refunding the national debt.

All I'm asking is forget Republicans and Democrats. I'm getting sick of it, absolutely sick and tired of people going for partisan advantage. I'm not saying you are. I'm just saying, in general. I'm trying to say it's happened since January or it was all Franklin Roosevelt's fault or somebody else's.

Who cares? Who cares? When are we going to face up to the fact that we've got a trillion-dollar debt that Congress, with both Republicans and Democrats in it, has been on a wild spending spree for years. And there is a trillion-dollar debt and there is interest of $120 billion a year. There are vested interests, with everybody's ox to be gored and they want to cut somebody else's but not theirs. And until we come to that agreement and quit playing games, whether it's the administration, Ronald Reagan, this Congress, Paul Volcker, we're going to be back here next year. We can have more Democrats in the House. We can elect a Democratic President in 1984 and nothing's going to change except the people will suffer until we quit playing partisan games and trying to assess blame and wake up to the arithmetic—the arithmetic of what has been built up over a long period of time.

Senator Sarbanes?

Senator **Sarbanes**. Mr. Chairman, well ahead of any discussion of playing partisan games is the question of whether you're going to get the truth and the facts.

Chairman Weidenbaum, I listened to your response to Senator Riegle. What did the administration estimate that the deficit would be when it submitted the budget to the Congress this year?

Mr. **Weidenbaum**. For fiscal 1983?

Senator **Sarbanes**. Yes.

Mr. **Weidenbaum**. Approximately $103 billion. I do this from memory, you can appreciate.

Senator **Sarbanes**. It was under $100 billion, wasn't it?

Senator **Dixon**. I think originally $97½ billion.

The **Chairman**. $96 billion.

Senator **Sarbanes**. You were very careful to have it under $100 billion, weren't you?

Mr. **Weidenbaum**. I'm not sure of the meaning of that.

Senator **Sarbanes**. Then it was examined and everyone agreed that it was in the range of $160 billion to $180 billion, isn't that correct, including the President himself?

Mr. **Weidenbaum**. You're referring to estimates in the absence of any budget cuts or revenue increases?

Senator **Sarbanes**. I'm referring to an accurate estimate of what you submitted.

Mr. **Weidenbaum**. I don't associate—of course, I defer to the Budget Director on these matters—but I don't associate——

Senator **Sarbanes**. The CEA is a professional organization, supposedly. I spent a good year of my life working for Walter Heller when he was the chairman. I know the enormous pride within the organization in its professionalism. I think there's serious question now that that professionalism has been compromised.

On Friday, the 2d of July——

Mr. **Weidenbaum**. I object to that, Senator.

Senator **Sarbanes**. I'll give you the basis of that assertion. On Friday, the 2d of July, the New York Times carried an article concerning the resignation of Jerry L. Jordan, a member of your Council.

Mr. **Weidenbaum**. That's right.

Senator **Sarbanes**. In that article, it says, and I quote:

> Mr. Jordan was known to have had some problems with the Administration's budget forecasts for 1982 through 1985, which formed the basis for the President's original budget proposal for the Fiscal Year 1983. He was one of the first economic officials in the Administration to acknowledge that the revised mid-year forecast which was issued in mid-July, 1981, just before the President's tax bill was considered in Congress, was not properly done and would have shown a worsening deficit picture if it had been.

What's your comment on that?

Mr. **Weidenbaum**. I never heard those statements. I read that hearsay in the paper. But it's quite clear that as the economy unfolded, as Congress acted on the tax program and on the spending proposals, that the deficit was going to be larger than originally estimated. There was no question about that as the year progressed.

The question, of course, and this goes back to the chairman's opening discussion, was the ability to pinpoint those numbers. It's quite clear that enacting fewer budget cuts and more tax increases than had been assumed in the estimates would have reduced the deficit.

Senator **Sarbanes**. Are you now engaged in an exchange with the chairman of the Joint Economic Committee, Congressman Reuss, with respect to working papers of the CEA, which show that the forecasts were much more pessimistic than what was stated in public?

Mr. **Weidenbaum**. The short answer is no, because, one, these were not working papers of the CEA. But two, what Mr. Reuss is referring to is the quarterly breakdowns, which add up to the published annual numbers.

By the way, ever since March, 1981, in public testimony, I pointed out the likelihood of one or more quarters of negative growth last year.

Senator **Sarbanes**. Chairman Reuss said:

> The Administration concealed from the American public information it had that Administration policies would produce a full-scale recession. At the same time this information was available, the American public was being told that we were on the verge of recovery and sustained growth.

Mr. **Weidenbaum**. I guess he wasn't paying attention to my testimony before his committee when I said——

Senator **Sarbanes**. I think he was paying attention to your testimony.

Mr. **Weidenbaum**. Excuse me?

Senator **Sarbanes**. I think he was paying attention.

Mr. **Weidenbaum**. Well, in March, 1981, and in many subsequent public statements to his committee and other committees, I said that we had a soft, soggy economy at the time and that I wondered about the prospects of one or more quarters of decline.

Senator **Sarbanes**. Mr. Chairman, I remember very, very vividly a session before the Joint Economic Committee and what I perceived to be the acute embarrassment of Professor Jordan with respect to the testimony which the Council had submitted and that, I think, is supported by this Times article which I just quoted.

Let me ask you this question. We asked Chairman Volcker yesterday whether he thought he was pursuing the monetary policy which the administration wished him to pursue?

He said, well, he thought so, but we would have to ask the administration about that. I did pursue with him the question of whether it was, at least, his perception that he was pursuing a policy which you wished him to pursue? And he said, yes, that was the case.

So at least that's the perception he has, that he's on track with you. And I take it that your testimony here this morning is to the effect that, indeed, the Federal Reserve is on track with the administration with respect to the monetary policy which it is pursuing. Is that correct?

Mr. **Weidenbaum**. Approximately. I use somewhat similar, although not identical, language to the effect that we're on the same wavelength. We consistently supported their policy of slowing down the growth of the money supply.

I tried to word that, frankly, consistent with my awareness of the independence of the Federal Reserve, that it is their decision and their determination, of course.

Senator **Sarbanes**. Is it your assertion that West Germany has not had any money growth since 1960?

Mr. **Weidenbaum**. No, that's not what I said. West Germany has experienced nearly constant money growth. In other words, the money growth, quite clearly, has been maintained. It hasn't fluctuated as sharply.

Senator **Sarbanes**. In other words, there's been money growth.

Mr. **Weidenbaum**. Of course.

Senator **Sarbanes**. At what rate?

Mr. **Weidenbaum**. I don't specify in my statement.

Senator **Sarbanes**. Could you tell us that?

Mr. **Weidenbaum**. I'll be glad to supply that for the record (see p. 123).

Senator **Sarbanes**. You don't have that in mind?

Mr. **Weidenbaum**. At my fingertips? No, sir.

REDUCTION OF MONEY SUPPLY

Senator **Sarbanes**. Now, is it your view that there should be a reduction in the growth of the money supply in this country?

Mr. **Weidenbaum**. From the level that obtained a year and a half ago? Oh, yes, sir, a reduction in the growth rate of the money supply. For example, the second half of 1980, which I think is the appropriate base——

Senator **Sarbanes**. No, I'm asking whether at the moment, do you think that the next step forward would be to reduce the growth in the money supply?

Mr. **Weidenbaum**. In the very short-term, I think that it's appropriate for the Fed to aim at the top end of the target range, as Chairman Volcker stated yesterday.

Senator **Sarbanes**. Well, what are the factors that you consider in trying to determine how the money supply should move?

Mr. **Weidenbaum**. A variety. First of all, the Fed sets those target rates and we have consistently supported them because they're consistent with our projections.

Senator **Sarbanes**. Well, what should they consider? What is it that you should consider when you set the target rate?

Mr. **Weidenbaum**. I wouldn't presume to instruct the Federal Reserve on how to set the target ranges. What we did do——

Senator **Sarbanes**. I'm not asking you to do that. I'm just asking you what are the factors that you should be looking at in reaching a judgment on what the target rate should be?

Mr. **Weidenbaum**. Target rate—the target range as opposed to the movement within the range in a given point in time.

Senator **Sarbanes**. You have to make some judgment whether they're doing a good job or not. What are the factors you look at in making that judgment?

Mr. **Weidenbaum**. First of all, in the February 1981 white paper, we stated the objective of reducing the growth rate of the money supply between 1980 and 1986 by about one-half. And therefore, the reductions in the targets that the Fed has announced since then are consistent.

Senator **Sarbanes**. Well, what is your premise as to how an economy will function? If an economy is expanding, is there need to have a growth in the money supply to accommodate expansion?

Mr. **Weidenbaum**. Oh, of course. The serious question is how rapidly, because——

Senator **Sarbanes**. The West Germans have been expanding their money supply, haven't they?

Mr. **Weidenbaum**. Of course. Growth in the money supply is what we're talking about. But we've seen, unfortunately, when that growth is too rapid, it only exacerbates, it only feeds the inflationary pressures.

Senator **Sarbanes**. So you think that the growth in the money supply should be cut by half; is that correct?

Mr. **Weidenbaum**. Between 1980 and 1986. That's the target we set in our economic white paper in 1981.

Senator **Sarbanes**. What is your assumption about what's going to happen to the growth of the economy between 1980 and 1986?

Mr. **Weidenbaum**. We assumed in the white paper long-term growth, significant long-term growth, brought about in good measure by a series of tax cuts.

Senator **Sarbanes**. Assuming——

Mr. **Weidenbaum**. If I may attempt to answer the remainder of your question, Senator, in terms of where the Fed should aim, I think it's apparent that the second half, for about 6 months in 1981, approximately April to October, the money supply hardly grew at all. And therefore, I think it's not surprising at all——

Senator **Sarbanes**. Were you supportive of that?

Mr. **Weidenbaum**. In retrospect, I think that that was too slow.

Senator **Sarbanes**. Were you critical of it at the time?

Mr. WEIDENBAUM. In my informal meetings with the Chairman of the Federal Reserve, I did give my advice.

Senator SARBANES. Were your public statements at the time supportive of the Fed's policy?

Mr. WEIDENBAUM. The policy, you appreciate, Senator, was to attain the growth targets. The practice was sometimes different. From time to time, frankly, I needled them and said I wish their aim would improve in achieving their policies.

Senator SARBANES. You needled them, where?

Mr. WEIDENBAUM. In various public statements, testimony.

Senator SARBANES. You did needle them in public statements?

Mr. WEIDENBAUM. In fact, I'd say we endorsed the target. Their policy is embodied in the targets. I noticed that sometimes they are above the targets, sometimes they're below the targets. I don't mean this critically, but I wish their aim would improve and I'm sure they do, too.

Senator SARBANES. That's some needle. Well, my time has expired.

The CHAIRMAN. Senator Dixon?

GRANT ITEM VETO POWER TO THE PRESIDENT

Senator DIXON. Chairman Weidenbaum, you said in your testimony that you would like to see more fiscal restraint by the Congress. Yesterday, when Chairman Volcker was here, he expressed the view that one of the best things that the Congress could do would be to grant item veto power to the President.

We have that power in my State with the Governor and it has achieved remarkable financial savings in my State. I believe that 43 of the 50 States actually give the Chief Executive an item veto power.

Do you support that concept?

Mr. WEIDENBAUM. I cannot speak for the administration on that budget matter, but personally, as a long-term student of the budget, I think it's a fine idea.

Senator DIXON. Your testimony, I think it can be fairly said, Mr. Chairman, is basically an endorsement of the general policies of the Fed. Would that be a fair characterization?

Mr. WEIDENBAUM. That's right. Yes, sir.

Senator DIXON. And you've indicated in there that the policy of the Fed, which this year targets money growth of 2½ to 5½ percent, if I recall correctly, is acceptable to you. I believe you've indicated, or at least implied here, that you felt the high side of the target range would be a more acceptable policy for the Fed, in your view.

Mr. WEIDENBAUM. Well, what I really was doing was commenting on Paul Volcker's testimony here before your committee yesterday, where he indicated that the Federal Reserve would be aiming primarily to operate at the top end of the range and indicated circumstances in which they might occasionally go above it.

And it strikes me that that is appropriate for the circumstances.

Senator DIXON. That would be your view as Chairman of the President's Council of Economic Advisers, that that target range, the high side of it, at least, would be acceptable, from your standpoint.

Mr. **Weidenbaum**. Under those circumstances, yes.

Senator **Dixon**. And that was basically the policy last year.

Mr. **Weidenbaum**. Well, no. Last year, the policy was to operate within the range, and as I pointed out to Senator Sarbanes, for 6 months, they operated without any growth. And then the growth was quite rapid from about November on. And the whole thrust of my statement that I prepared for your committee is that I think we'd have a healthier economy if the Fed could achieve a more stable growth. And I've gone into the technical details as to how to try to achieve that more stable growth pattern.

Senator **Dixon**. But essentially, the policy of the Fed, in the time that I've been here and the time of this administration, has been a monetary growth in the target area indicated here, and that has been the stable policy of the Fed throughout this administration's tenure to date; would that not be a fair statement?

Mr. **Weidenbaum**. Our position has been consistent in terms of supporting the Federal Reserve in its policy of slowing down the growth of the money supply and we've consistently supported the specific targets that they independently set.

Senator **Dixon**. I characterized the presentation of Chairman Volcker yesterday as more of the same. And I would say that that is the policy he has represented to us as the policy of the Fed. Would that be your view?

Mr. **Weidenbaum**. I need to distinguish between policy and practice because, in practice——

Senator **Dixon**. I'm talking about the target ranges, not the variations.

Mr. **Weidenbaum**. Well, you see, last year, the Fed, the year as a whole undershot the target range. They came in below the bottom end of the target range.

Senator **Dixon**. You'd like to see them on the high side this year?

Mr. **Weidenbaum**. Having undershot last year, I think it's appropriate to be on the high side thus year, especially with the slow recovery that's underway. But as a long-term matter, I think they ought to operate within their target.

TARGETING INTEREST RATES

Senator **Dixon**. How do you feel about targeting interest rates, looking at interest rate as well as monetary supply, as was done prior to October 1979? What's your view on that policy?

Mr. **Weidenbaum**. Very negative.

Senator **Dixon**. You think that's a mistake?

Mr. **Weidenbaum**. Yes, sir. That was the key to the inflation that we've been suffering from and that we have tried so painfully to unwind.

It sounds attractive, I know, but we found that it doesn't work.

Senator **Dixon**. Basically, your opinion is that you endorse the 2½ to 5½ percent target range in monetary growth of the Fed. You oppose the idea of targeting interest rates, as had been done up until October 1979. And taking into account the variables that might occur between the bottom and the high side of that range, you find that acceptable policy.

Mr. Weidenbaum. Yes, sir.

Senator Dixon. Well, then, I guess my question would be, given the fact of the terrible economic experience in the country that we're all aware of right now—for instance, I'm a graduate of your fine university, Washington University, September 1949. In my entire adult career, in employment, owning businesses, needing to meet a payroll, making a profit sometimes, experiencing a loss other times, there's never been an economic situation in this country in my adult lifetime, in my view, as severe as the one that we have right now.

So I guess my question would be: What, then, does it take for the Fed to make some kind of a response to the economic situation in the country other than what you find acceptable in the policy they apply right now to respond to interest rates, the dramatic unemployment situation, and the economic experience in the country?

Mr. Weidenbaum. First of all, I don't think that the Federal Reserve is the only game in town, so to speak.

Senator Dixon. I can see that.

Mr. Weidenbaum. A while ago, we were discussing the Federal budget, and I don't mean this in either a partisan fashion or Congress versus the administration, because I think, in the course of many administrations, Republican and Democratic, Congress and the executive branch have developed a stream of Government spending which I think is too high, which has been growing too rapidly; and that I think dealing with that, slowing down the growth of Government spending, which is not part of the Fed's responsibility, is a very integral part of economic policy in our country.

For example, if the deficit were half the size that it is today, I think that this economy would be in a lot better shape. Interest rates would be lower.

Senator Dixon. Do you really think on the basis of your experience—and I grant you all of your fine reputation. I think well of you, personally—do you really believe that the recession in this country has bottomed out? Is that your statement to this committee at this point in time, in July 1982, that this recession has bottomed out?

Mr. Weidenbaum. Yes. In fact——

Senator Dixon. Things are going to get better from here on in? Prosperity is just around the corner?

Mr. Weidenbaum. I didn't quite say that.

Senator Dixon. You have said that, I think, here. Prosperity is just around the corner.

Mr. Weidenbaum. There's an old forecasting rule: If you ever make a good forecast, never let them forget it. In late March of 1982, I stated in a speech in, I guess, New York City, that I thought the economy had hit bottom. Well, we've now learned as of 10 a.m. this morning that for the period of April through June, the economy did grow, a modest 1.7 percent in real terms, after boiling out the effects of inflation.

Senator Dixon. Mr. Chairman, you know, you're familiar with the St. Louis area. That's why I can visit with you this way. I just saw some unemployment statistics. For instance, in my hometown of Belleville, a beautiful, lovely city, as you know. Many live in my town and work in St. Louis. Unemployment is 16½ percent. They were talking about all the cities around, and I want you to listen to this because you know the area.

Granite City, over 20 percent. That's a steel town. You'd understand that. East St. Louis, 10½ percent. Now you and I know that in East St. Louis, 40 percent of the people probably don't have work. You know why the figure is 10½ percent? They don't count them any more. They've been out of work under this administration so long, they don't even count them any more.

Now the statistics—we have 11.3 percent unemployment in my State. Bankruptcies there in the first quarter of this year were higher than in the first quarter of 1933.

I go home every weekend. I listen to you and to other witnesses, men whom I respect, whose reputations are excellent, hearing on the Hill about what a wonderful situation things are right now and everything's getting better. The recession has bottomed out. And I go back home and nobody tells me that on Main Street. Somebody's wrong in this country.

Mr. **Weidenbaum**. I share your view that if that is the posted unemployment rate for East St. Louis, it's far too low. The reality is much more severe. And it's been true a long, long time, to everyone's misfortune.

Nevertheless, the Midwest, our region of the country, as a fact, has been much harder hit than many other regions of the country.

Senator **Dixon**. But could I—I know my time's just about up, Mr. Chairman. Let me say this in conclusion. Not too long ago our distinguished chairman and Mr. Lugar, the distinguished senior Senator from Indiana, two men who I think would share a reputation as strong supporters of the President, at the top of the list with anyone whom you might suggest in the Congress of the United States——

Mr. **Weidenbaum**. Indeed. I agree with that.

HOUSING BILL VETOED

Senator **Dixon**. Men who are friend to the President and his interests, had a bill to respond to the housing needs in our country. Housing starts in my State dropped last year 77 percent. And the year before was a lousy year. It would have employed 650,000 people in this country to put carpenters, plumbers, bricklayers, masons, and others to work.

I can understand the philosophical differences of the President with that idea, but he vetoed it. And I come to hearings here and I hear my friend, Mr. Volcker, say that we're going to stick to the game plan we've had for 2 years, more of the same, and you endorse it and say it's fine, maybe get on the high side instead of the low side or the target ranges. And I don't see anybody suggesting a thing to do about what's happening in the country.

When I spoke in Rock Island this last Sunday and spoke to people there and found out that 26,000 people who want to work in Rock Island can't get work, and they want it, I would like to know how in the world things are going to get better if all we do is have meetings and say things are going to be OK if we stick to the plan?

Mr. Weidenbaum. Senator, I think that we need to learn from past experience. The sad experience of the past is something like the Lugar bill, when it gets enacted—I recommended a veto, I make no bones about that—comes onstream far too late. But in this environment, I think legislation like that would only push interest rates up further.

Senator Dixon. Well, I hope it came far too late, Mr. Chairman. I respect you. I hope your opinion is right. But I don't see things changing in the country. I don't want to suggest a banana before we've got a banana. But I don't see things getting better in the country. I respect your opinion, but if they're not getting better in the country and we don't do anything here, next year we'll be talking, but it will be too late.

BAILOUT APPROACH

Mr. Weidenbaum. I do believe that the answer is not for Congress to take the kinds of actions that will increase the deficit because if there is any part of the economy that will be hardest hit by a further increase in interest rates, it's the housing industry. I think that's why you found parts of the housing industry supporting the President's veto. They realize that if we shifted to the bailout approach, to well-intentioned programs to spend more Federal money to specific sectors of the economy, which increase the deficit and increase pressure on interest rates, we would hit hardest those sectors of the economy that we're trying to help the most.

Senator Dixon. I thank you and it's nice to see you again.

Mr. Weidenbaum. Thank you, sir.

The Chairman. Mr. Chairman, let me just make a comment on the so-called Lugar bill. If you or the President or anyone else want to disagree with the philosophy, and I normally would, too, except sometimes you have to get the ox out of the mire.

The thing that bothers me is that when that was referred to as a bailout bill in terms of cost, without regard to the structure or how it should be done, because besides being chairman of the Banking Committee, I also happen to be chairman of the HUD Independent Agencies Appropriations Subcommittee. And there are some facts that ought to be known.

President Carter requested 225,000 units of subsidized housing. President Reagan requested 175,000 units of subsidized housing. That subcomittee cut it to 150,000 and did the President 25,000 better, as did this authorizing committee.

Then in December, we cut it to 143,000 additional cuts; 52 percent of all of the recisions in the 1981 budget came out of that subcommittee. In 1982, 82 percent came out of that subcommittee. When the urgent, urgent, urgent March supplemental came up, that didn't pass until last week. And in that bill, the bill came over from the House—every other single subcommittee of the Senate, the Senate Appropriations Committee added money to that bill, except one—the HUD Independent Agencies Subcommittee, which took an additional $6.9 billion out, which made the total bill, which made all the other subcommittees whole so that we could say the

Senate had a bill that was lower in total cost than the House supplemental.

So we had to take more than all—well, they all added. Not more than they took. They took none.

The Lugar, not as compromised in the conference, but out of committee, added $1 billion back in, leaving only a net reduction of $5.9 billion.

Those are facts, not opinions, to justify mine or Senator Lugar's position. Simply flatout facts. So if people want to oppose it on philosophy and say it's too late, we shouldn't have done it, all of that, OK. But it is totally unfair to call it a bailout.

And people would come up to me on the floor and say, Jake, Dick, I would support your bill if you found me a billion-dollar offset. Billion-dollar offset? We had a $6.9 billion offset just in that bill. And 52 percent of the rescission in 1981 and 82 percent in 1982.

Now I would suggest my subcommittee has done its share and it was not fair at any point along the line, for whatever other reasons you wanted to veto that bill, to say that the Lugar bill was a budget buster and a bailout. That simply is not the truth.

Mr. **Weidenbaum**. Mr. Chairman, I'm ready, willing, and most anxious to state that if every other subcommittee bit the bullet the way your subcommittee did, this country, as well as the budget, would be in far better shape than it is today.

I can only add, and that needs to be underscored, I don't think the public realizes the contributions of your subcommittee.

The **Chairman**. I'm not looking for compliments. I'm just trying to refute that this was a bailout bill to add $½ billion back in, $1 billion and then $½ billion when it came out of the conference committee. You characterized it as one of the budget-buster types of bills.

Mr. **Weidenbaum**. Well, from where I sit, almost every bill is a budget buster because of those triple-digit deficits. In good conscience, I can report that every time there is an issue, I have urged the President to recommend less spending rather than more spending on every single department, every single agency, where the issue has arisen.

The **Chairman**. Well, my only point is I would suggest more pressure on some of the other subcommittees.

Mr. **Weidenbaum**. Amen.

The **Chairman**. And let them do their share of the budget cutting as well, rather than lumping it in one particular area. I would hope that we can finish with one more round because we do have two additional witnesses. So I will not take any more of my time because we do have two distinguished witnesses that I would not like to run short of time.

Senator Riegle?

Senator **Riegle**. I'll try to move as quickly as I can in light of that, Mr. Chairman. You make a good point.

David Stockman is quoted in the U.S. News & World Report for July 19—you may have seen this interview. And this is the question that is posed by the magazine and here is his response:

Question: Do you give Reagonomics credit for the Federal Reserve Board's tight money policy?

Stockman's answer: "We endorsed it. We urged it. We have supported it."

Is that accurate?

Mr. WEIDENBAUM. I'd let Dave Stockman speak for himself.

Senator RIEGLE. Well, he's speaking for the administration.

CHARACTERIZING FED'S MONETARY POLICY

Mr. WEIDENBAUM. He's the Budget Director. I've never called the Fed's policy tight. I've called it restraint because if you look at the growth of the money supply in 1982, today, it certainly isn't tight.

Senator RIEGLE. Well, how would you characterize it? He is saying here that in terms of the Federal Reserve's monetary policy, "We endorsed it. We urged it. We have supported it."

Is that an accurate statement?

Mr. WEIDENBAUM. The policy. But I describe the policy not as one of tight money, but as one of restraint.

Senator RIEGLE. I'm not sure it matters how one characterizes that. Ten people might have different views. But the fact of the matter is that Federal Reserve policy, however one describes it——

Mr. WEIDENBAUM. Policy.

Senator RIEGLE [continuing]. He says that the administration endorsed it, urged it, and supported it. Is that an accurate statement?

Mr. WEIDENBAUM. Yes, but remember, the key word is "policy." That isn't to endorse each and every move that the independent Federal Reserve has made.

Senator RIEGLE. So you're not challenging his statement here.

Mr. WEIDENBAUM. My policy is to explain my position and to let my colleagues explain theirs.

Senator RIEGLE. Now earlier you said in your quote—I missed the actual quote, that "prosperity is just around the corner." Did you, in fact, say that today?

Mr. WEIDENBAUM. Not guilty. [Laughter.]

Senator RIEGLE. OK; Let me tell you what I did hear with my ears from your lips, and that is you said that the economy is turning up. That you did say.

Mr. WEIDENBAUM. Yes, sir.

Senator RIEGLE. OK; Now that is an important statement because you're the President's chief economic adviser. You're coming here in a series of important hearings. That is news. If it is your view and the view now of the administration that, in fact, the economy is "turning up," turning up, which is your phrase, that is a significant statement. And is that what you really mean to say?

Mr. WEIDENBAUM. Oh, yes, but it's not news because I state an opinion. It's news because at 10 a.m., the Department of Commerce released the official numbers on the GNP for the second quarter of 1982. They estimate an increase in real GNP for the second quarter of 1.7 percent.

Senator RIEGLE. I don't want to get into that in any great detail.

Mr. WEIDENBAUM. That's an upturn.

Senator RIEGLE. I understand. But you and I both know that the Commerce Department, when they make these estimates, often has to adjust them. They also produced an estimate on housing starts. They had to go back and change that. They had to scale it back.

They have on a number of others as well. It may well be that this will prove to be what the true performance was, and perhaps it won't. Maybe they'll have to adjust. They made a series of adjustments. In fact, it's become more common in the last year to have to make major adjustments than it is to leave the numbers stand as is.

I don't know whether that's the case here or not.

Mr. **Weidenbaum**. You're right.

Senator **Riegle**. So I don't know. I hope that the numbers are right. I know the unemployment data. If anything, when unemployment experts across the country look at it, they feel it's understated for a variety of reasons. Partly seasonal facts, partly the fact that we don't, in the numbers, count people who have been unemployed and exhausted their unemployment benefits.

In Michigan, for example, just to give you an idea, in our State, we have had unemployment—this is an important fact—above 10 percent for 32 consecutive months—32 consecutive months. If you can imagine what that would do in terms of devastating an area. We happen to be the eighth largest State, so I'm not talking about a small neck of the woods—this is increasingly a pervasive national problem.

I don't want to rehash what we said before, but you've got a number of other critical measurements like unemployment, like housing starts, like business failures, where the news is getting worse. Unemployment is rising. Business failures are rising. Liquidity problems among businesses are rising. Farm foreclosures are rising. The problem of the thrift industry is getting worse.

So there is a wealth of data there. Now you may not see it. You may not value it as highly.

Mr. **Weidenbaum**. Oh, I monitor those statistics.

Senator **Riegle**. But they don't go away. And this preliminary estimate of second quarter growth by the Commerce Department doesn't in any way address these enormous crisis-scale problems in the interest rate sensitive sectors of the economy. And that's, of course, what we're here to talk about today, is monetary policy.

DISCOUNT RATE LOWERED

Now I think the Fed, when they just lowered the discount rate yesterday by half a point, I think would have done better had they lowered it by a full point. I think we're at a stage now in the economic situation where we still need the other kind of meeting led by the President that I spoke about—a real serious budget meeting to get the deficits down and get a corresponding change in the monetary policy that would bring interest rates down.

But without that taking place, which I would much prefer to see, if the Fed is going to have to act without any direct help from the administration at this point leading this kind of process, which should involve members of both parties, would you support them taking the discount rate down, say, a full point rather than a half point?

Mr. **Weidenbaum**. I have tried to avoid being put into the position of seeming to give public instructions or even private instructions.

Senator RIEGLE. I'm not asking you to instruct them. I want your professional opinion as to whether or not a full point drop in the discount rate would be good medicine, given the overall mix of economic facts today, or would it not? I mean, would you feel that you would say that it would be?

Mr. WEIDENBAUM. Well, you appreciate, I look upon interest rates more as as result than a cause. So if the cause of high interest rates——

Senator RIEGLE. We're not talking about high interest. We're talking about the discount rate, which is the Fed rate.

Mr. WEIDENBAUM. It reflects the reality that market interest rates have been coming down in recent weeks. I think that's the key reason we saw a drop in the discount.

Senator RIEGLE. Well, would you have been upset if they had dropped it a full point?

Mr. WEIDENBAUM. Not at all.

Senator RIEGLE. So you could certainly accept and feel good about a full point drop?

Mr. WEIDENBAUM. Well, I've tried to avoid taking any position on the specific administrative actions of the Fed. I do think that the kind of monetary policy that Paul Volcker described in his testimony yesterday will get us declines in the interest rates.

Senator RIEGLE. I want to extend another invitation. I made a suggestion earlier. This is in the form of an invitation. I think it would be healthy and constructive if the President and yourself and the other economic advisers would come out into the country into some of the centers of high unemployment, and I would list Detroit, really, at the top of the list, because it's——

Mr. WEIDENBAUM. I've just come back from several days in St. Louis, which is suffering, as Senator Dixon pointed out.

Senator RIEGLE. Let me tell you what my idea is here. I think it would be helpful to the President and to the administrative economic policy people, yourself and the others, if you were to come into some of the major cities where we have massive unemployment and spend several hours talking informally with unemployed workers, with business people who either have just lost their businesses or are about to—any number that you can find and talk to—many of them, by the way, who were ardent supporters of the President in 1980. So you would not be playing with a stacked deck in talking to these folks.

But they are coming to me in increasing numbers, just as Senator Dixon said they are in Illinois and across the country, because they are in desperate straits. They cannot survive. They are being ground down and destroyed day by day. I think the President and those of you who are his chief economic advisers owe it to yourselves, and I think you owe it to the country, to the people who are caught in this situation, to sit down in a series of meetings and to discuss this firsthand, to get a feel for it.

I'm not talking about some kind of a show business thing or a rigged thing. I think it's better if the press is kept out, so it doesn't become a media extravaganza. I think it would be very constructive if 20 or 30 unemployed workers would have a chance to talk directly to the President, just talk with him, just be able to explain what it is they're facing.

I don't sense that that is happening. I follow quite closely what goes on and I don't get the feeling that the President has had any series of meetings with groups of unemployed workers or businesses that are on the verge of bankruptcy or business people who have just lost their businesses. I think it would be constructive for the country, for the economic policy process, and for these people if you could start to do that.

And I'd like to ask you to come to Michigan. I will play whatever helpful part I can in identifying people like this or meeting places where this could go on. But I think you owe it to the country to do this.

Mr. **Weidenbaum**. Senator, I've just been back for a few days in St. Louis, which was anything but a media event, where I spoke to many people at every stage of the happiness spectrum, from owners of growth industries to people out of work, to people whose companies were in trouble, to students who were looking for jobs, to students who found jobs. And I think that that is useful. And there's been absolutely no shortage of groups coming into the White House, meeting with the President, the Vice President, members of the Cabinet, with the senior staff.

Senator **Riegle**. Have you invited in a group of unemployed workers? Has there been that kind of meeting?

Mr. **Weidenbaum**. Per se, not to my knowledge. Have there been representatives of groups that have suffered high unemployment, such as blacks and Hispanics? Yes, many. Have there been meetings with businesses, small as well as large, especially those who are suffering from the high interest rates? Innumerable.

Senator **Riegle**. Well, Mr. Weidenbaum, we've got 10½ million people out of work in the country. That is a conservative estimate. Those are the official Government figures. Can't we get some of those people, the ones who are bearing the brunt of what's happening today, can't we give them an opportunity to sit down in a serious, working discussion with the President?

Mr. **Weidenbaum**. As an economist, I'll have to ask you the question: And what do we ask them? Having been unemployed—not recently—I understand how many of them are suffering and suffering deeply. But the serious question is: How can you reduce unemployment, how can you restore a healthy economy, without getting back into the escalating double-digit inflation——

Senator **Riegle**. Well, I think——

Mr. **Weidenbaum** [continuing]. And very frankly, I think——

Senator **Riegle**. Let me tell you something. It isn't sufficient. It isn't sufficient to say there is no way. I mean, if you believe that, you shouldn't stay in this job another minute. Obviously, there is a way. There have been suggestions offered. A budget meeting of the type that I suggested earlier that could really do something about the deficits and, in turn, monetary policy. There are any number of ideas. You folks are standing pat. That's the problem.

Mr. **Weidenbaum**. On the contrary. First of all, we have encouraged the Congress, and the ball is in your court, if I state that correctly. You are currently acting on the budget right now, which is appropriate, which is proper. I wish you well in terms of cutting the budget more rather than less.

Senator **Riegle**. My time is up.

Mr. **Weidenbaum**. I don't see the need for conferences, but the will to cut spending.

The **Chairman**. Senator Sarbanes?

Senator **Sarbanes**. Mr. Weidenbaum, in response to Senator Garn's comment that every bill is a budget-buster, is that true of bills that cut the revenue base?

Mr. **Weidenbaum**. I had in mind on the spending side, but I must agree that the short answer to your question is yes.

Senator **Sarbanes**. I think that's an important point to make, don't you?

Mr. **Weidenbaum**. As an economist, I couldn't have given you any other answer.

FOREIGN ECONOMIC GROWTH

Senator **Sarbanes**. Are there countries which you think have done a better job with their economy in the decade of the 1970's—West Germany, for example, or Japan?

Mr. **Weidenbaum**. Yes.

Senator **Sarbanes**. You think they have done a better job?

Mr. **Weidenbaum**. I haven't made a formal comparison to offer the committee. But in terms of their record on inflation and on growth, yes, we don't lead the parade. We didn't lead the parade over the 1970's.

Senator **Sarbanes**. What, then, is your comment on the fact that the annual average trend growth rate in the money supply, 1970 to 1980, in West Germany was 9½ percent, Japan, 13.4 percent, and the United States, 6.1 percent?

How do those figures, and the comment you just made about the effective performance of those two economies, square with your assertion earlier that we need to cut the growth rate of money in this country?

Mr. **Weidenbaum**. In my paper, I discuss the technical subject of velocity in great detail. My understanding is that velocity of the money supply in this country has been much more rapid than the velocity in Japan or in West Germany.

Senator **Sarbanes**. Are you asserting that as a fact?

Mr. **Weidenbaum**. That is my understanding. My staff experts have informed me of this. I'll be glad to give you the details for the record.

[The following information was subsequently supplied for the record:]

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

July 29, 1982

Honorable Paul S. Sarbanes
Committee on Banking,
  Housing and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Sarbanes:

This letter supplies the information requested at the hearings of the Senate Banking Committee on July 21 regarding the growth of money and its velocity in Germany and Japan compared to the United States. I was asked to square my assertion that money growth in the United States needs to be cut with the fact that during the 1970s U.S. money growth was actually lower than in Germany and Japan, where economic performance was better.

Actually, as shown in the attached table, the economic performance of these three countries over the entire decade of the 1970s was not very different. However, in the last half of the decade the inflation performance of Germany and Japan improved compared to that of the United States. For the decade as a whole, both inflation and real growth were somewhat higher in the United States than in Germany, but lower than in Japan.

The United States experienced about the same growth of nominal GNP as these countries in the 1970s, despite lower M1 growth, because the growth of M1 velocity was substantially greater in the United States. A more highly developed financial system, combined with restrictions on interest payments on M1 balances, prompted the public to economize on its holdings of M1 over time, creating an annual growth of M1 velocity in the United States of 3.6 percent in the 1970s. In contrast, M1 velocity actually fell in both Germany and Japan.

The effect of money growth on inflation is clearly illustrated when the first and second halves of the 1970s are compared. Annual M1 growth in Germany was cut by an average 1.9 percentage points in the last half of the decade, with a resulting decline in the annual average inflation rate of 2.7 percentage points. Japan reduced its annual M1 growth by 11 percentage points on average, producing a 5.6 percentage point decline in the annual inflation rate. However, annual average M1 growth in the United States rose by .9 of a percentage point, and the resulting increase in inflation was .7 of a percentage point, on average.

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Thus, in the latter half of the decade the German and Japanese record on inflation improved compared to our own. Paradoxically, U.S. money growth was lower than in Germany and Japan, but our inflation rate was higher. The reason for this is that the growth in the income velocity of M1 continued to be significantly higher in the United States. U.S. money growth must therefore be cut even more in comparison with these countries if we are to achieve a comparable degree of price stability.

I would also like to point out that, despite the reduction in M1 growth in Germany and Japan, the growth of real GNP improved in both countries. Over a period of several years a reduction in money growth only affects inflation, and any temporary effects on output and employment disappear. Over the long run, the rate of growth of real GNP is determined by the growth of labor and capital, and their productivity -- not by the expansion in M1.

Sincerely,

/s/ MLW

Murray L. Weienbaum

Federal Reserve Bank of St. Louis

1970-1980

(Percent Change at Annual Rates)	United States	West Germany	Japan
Growth of M1	6.6	9.2	13.7
Growth of M1 Velocity	3.6	-1.0	-1.3
Growth of Prices	6.8	5.2	7.1
Growth of Real GNP	3.2	2.8	4.9

1970-1975

	United States	West Germany	Japan
Growth of M1	6.2	10.2	19.3
Growth of M1 Velocity	3.1	-1.4	-4.2
Growth of Prices	6.5	6.6	10.0
Growth of Real GNP	2.6	2.1	4.7

1975-1980

	United States	West Germany	Japan
Growth of M1	7.1	8.3	8.5
Growth of M1 Velocity	4.0	-0.7	1.2
Growth of Prices	7.2	3.9	4.4
Growth of Real GNP	3.7	3.6	5.1

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Senator **Sarbanes**. I'd like to have those. In addition, also, if that is the case, to what do you attribute the difference in the velocity rates?

Mr. **Weidenbaum**. I have to confess that I have not made any study of velocity in Japan or West Germany, but I'll be very pleased to amplify——

Senator **Sarbanes**. Well, I also ought to make the further comment that the table I'm looking at indicates that the money growth rates in other countries were above those of West Germany and closer to those of Japan than they were to those of the United States. We, apparently, are an exception to the experience in all of these other countries.

Mr. **Weidenbaum**. Many of these other countries have had serious inflationary problems. The reason I compared West Germany and Switzerland is that these have been good examples——

Senator **Sarbanes**. But your point on West Germany was simply that they had been able to hold to a constant growth rate; not that they weren't—they may well be growing faster than we're growing, as these figures would indicate.

Mr. **Weidenbaum**. But the very notion——

Senator **Sarbanes**. The implication of your statement was, as I understood it, that we had allowed the money supply here to grow more than they have. That's, in fact, not the case.

Mr. **Weidenbaum**. More volatile and more rapid, so more unpredictable.

Senator **Sarbanes**. Well, it may be more unpredictable; it's not greater in terms of the percentages, as these figures I've just given to you would indicate.

Mr. **Weidenbaum**. Well, that shows the problem that faces monetary policy in the United States, because over the years, it has——

Senator **Sarbanes**. Now do you think that the high interest rates have contributed to the economic downturn?

Mr. **Weidenbaum**. Yes.

Senator **Sarbanes**. You do? Now you posited the deficit as the problem that we're trying to deal with, and I recognize that problem. Hasn't the economic downturn brought about a significant increase in the deficit?

Mr. **Weidenbaum**. Oh, by all means, yes.

Senator **Sarbanes**. So the high interest rates, which ostensibly are up there to check inflation, are in fact contributing to enlarging the deficit, which in turn heightens apprehension about this deficit and therefore, keeps interest rates high.

Mr. **Weidenbaum**. Of course. But we've never advocated the high interest rates; we've advocated policies to bring down the interest rates.

Senator **Sarbanes**. Now in response to Senator Riegle's question about the Japanese economy, its unemployment and its prime rate, isn't it also true that the Japanese deficit as a percentage of their economy is larger than ours?

Mr. **Weidenbaum**. Yes, and so is their savings rate.

Senator **Sarbanes**. And how about in West Germany? The same thing?

Mr. **Weidenbaum**. Yes, the savings rate and the deficits are both higher.

Senator **Sarbanes**. Are you familiar with the story in this morning's Washington Post on the Commerce Department, the announced revisions in personal income statistics stretching back to 1977?

Mr. **Weidenbaum**. I glanced at the story. I am generally aware of the revision that the Commerce Department has been making, yes.

Senator **Sarbanes**. And what was the thrust of that revision?

Mr. **Weidenbaum**. The personal savings rate was a little higher than had been reported.

Senator **Sarbanes**. Yes. I just want to quote this article. It says:

> The changes wipe out part of the sharp declines in the personal savings rate expressed as a percentage of disposable personal income that appeared in Government statistics beginning in 1977.

And it goes on to say that the supposed sharp drop in the savings rate was the premise on which the economic policy of the supply side theorists was developed, but it now turns out that that was a faulty premise.

Mr. **Weidenbaum**. As I always have tried to describe the situation, the supply of saving in this Nation in recent decades has not been adequate to finance the type of rising investment which is necessary for rapid economic growth. And I see no reason to change that position.

Senator **Sarbanes**. Thank you, Mr. Chairman.

FRUSTRATION OF POLITICS

The **Chairman**. Thank you. Mr. Chairman, I suppose I finish your portion of the hearing where I started: with the same amount of frustration of politics as usual without regard to political parties in this town. Again, as with Paul Volcker yesterday, I can remember the line of questioning from my colleagues on the Democratic side in making sure that we tied the administration to Volcker, and the only difference 2 years ago in 1980, before the election, it was Republicans on this side who were trying to tie Paul Volcker and Jimmy Carter together. And Chairman Schultz of the Council of Economic Advisers, the same line of questioning you've been getting today came from our side.

So I'm not assessing any blame to anyone. I guess—I don't know—I have a great sense of frustration that we can't maybe get out of our traditional roles in a two-party system and forget it for a while and see what we can all do together.

The criticisms about errors in estimates of this Administration are factual. They have been. It's for everybody to see. We start out with a budget estimate deficit of $45 billion. A lot of us felt it wasn't realistic and it shouldn't have been stated. As I say, it's been true the entire time I've been here, by both Republican and Democratic administrations, who, I guess, the tendency is always to try and present the most positive viewpoint rather than being totally realistic because you worry about the political consequences.

That is not peculiar to one party or another. They've both been guilty of it. And the ones who have made the greatest errors of all in estimation of budgets—not in just estimates—since I've been here in the Congress in our appropriations process. Year after year, we always seem to be suddenly surprised that we're spending a lot more money than we intended to at the beginning of the year.

So I just, again, express my frustration with the unbelievable problem abounding in this country and maybe I'm terribly naive and it's impossible for people elected to public office to forget what their party labels are, who happens to be the opposite, and say, hey, let's try and do something about it.

But we appreciate your testimony.

Senator SARBANES. Mr. Chairman, I'd like to make one observation on that comment. The criticism on this side of Chairman Volcker and of the Chairman of the Council and of the President in the previous administration was as sharp as it has been with respect to these witnesses. And if there's been any difference with respect to how things have worked, I think it has been a diminution of a comparable approach on the part of the other side of the aisle.

I think we were very sharp. I think a review of the transcripts during that period will demonstrate that. And I think that Chairman Volcker was taken to task as much, if not more so, in the previous administration by the Members on this side as he's been taken to task in this one.

The CHAIRMAN. Paul, there are a lot of Republicans who, from the very beginning, have not only been very critical of Volcker with this administration, but we have resolutions from both sides of the aisle before this committee for very structural changes in the Fed.

Senator SARBANES. We were also critical of the President for his economic policies, Mr. Chairman.

The CHAIRMAN. Well, and there's a lot of criticism from our side, too.

Senator SARBANES. I'm looking for it.

The CHAIRMAN. We're big boys and I think you—well, I have sat here and totally agreed with you on the inaccuracy of the estimates. But the point of it is, let's not kid ourselves, we can sit here and try and defend one side or another. There is plenty of blame for both sides and there is politics as usual going on throughout the entire Congress. I've seen it happen over and over again.

But certainly, Paul, there are always exceptions to that and I would agree with you: Members on both sides who do not participate in that. No doubt about it. But I saw people who were for the Panama Canal Treaty when Gerald Ford was President working on it and Republicans for it, Democrats against it. When Jimmy Carter proposed it, we had a certain number on both sides who just switched and suddenly, because Carter was proposing it, we shouldn't ratify the Panama Canal Treaty and others who went the other way.

That's a fact of political life and there are always exceptions to people on both sides of the aisle on this committee and the Congress who do not participate that way. I just feel that right now, the country is in such dire financial straits, that we ought to be able, a lot more on both sides ought to be able to rise above that.

Senator SARBANES. Mr. Chairman, I would agree with that, and on that point, I would simply make the observation on the Panama Canal treaties that I note that President Reagan made so much of it in 1976 in his primary campaign against Gerald Ford and so much of it in 1980 in his presidential campaign against Jimmy Carter, and yet has not uttered one word about the treaty since he took office and has reaped all the benefits which flow to the Nation from those treaties.

That's a good example, I think, of the kind of attitude you're talking about. I wish we had more of it.

The CHAIRMAN. But there are some people who are realistic enough to recognize that once something has been passed and ratified by two-thirds of the Senate, that it wouldn't serve much purpose, with all of these other problems, to yell and scream about it.

Senator SARBANES. Well, it wasn't recognized in 1980, after ratification had already happened. But it was recognized once the responsibilities of office came down upon the administration. I must say, to the administration's credit, that they have recognized the benefits of those treaties and why they protect our national interest. We have not heard one word about them, not a single word.

The CHAIRMAN. Well, but there are some of us who still think that it was a lousy treaty, and yet, I haven't made a speech on it for 2 years. There are other more important things to deal with. That's past history.

Senator Riegle wanted to make a final comment.

Senator RIEGLE. Mr. Chairman, I'd just like to make one parting comment to you, and that is this. I think the economy is in very serious trouble. I think, because of the continuing high interest rates, we have a genuine crisis in the interest-sensitive sectors of the economy. I think it is worsening rather than getting better.

MIDCOURSE CORRECTION

I believe we need a major adjustment in the economic policy, a midcourse correction, as has been described by many. And I think we need it now, right now. Not 6 months from now, 3 months from now, or at any other time. And I think the chance to do it is rapidly diminishing.

I speak now in terms of the administration leading the process which has to involve people on a bipartisan basis. And I urge you to monitor things very carefully because you have to be the person, more so than anybody else, that blows the whistle for the President. If a bad situation is developing where there is a need for an intervention to change the policy mix, incorporating the efforts of the Congress, you have to be the person to blow that whistle. And if you miss that—you know, I like you well enough that I don't want to see you end up some day as the fellow that they put it on your tombstone that, "Here lies Murray Weidenbaum, the economist who was in charge when the economy went over the cliff."

I mean, I don't want that to have to be there, and I know you don't, either.

But we're on a course right now that poses great dangers. And I think your chance to act now may become more and more difficult the longer you wait. I just want to leave you with that thought.

The CHAIRMAN. I suppose one of the ironies of this whole situation is the budget deficits wouldn't be nearly as big if inflation had not come down. So you win a partial fight on inflation and it compounds this other problem.

Let me just close, and hopefully, this will be the close. [Laughter.]

I want to repeat what I said yesterday at the end of the hearing, that regardless of whether people like the administration's policy, I happen to think that the policy is correct. I have supported it, as you well know, all the way along. But the ball really is in Congress court right now, without a doubt. Whatever the initial recommendations on the budget were—bad, good, indifferent, or whatever—the fact of it is that we have passed the budget resolution, which is a reduced deficit from the earlier projections, still way too high, in my opinion. But nevertheless, I have grave doubts as to whether Congress has the ability to discipline itself in the 13 appropriations bills to meet that budget target that was set by the two budget committees in both the House and the Senate.

I don't think, at least at this point in time, with July, August, and September left, 44 days, or however many it is, that the major responsibility for doing something about this economy at least to meet that horrible $103 billion or $110 or $130, lies upon the Congress. Nobody else can do anything about it. We are the only ones that have the ability to appropriate money.

I suppose what we need—Murray and Don may agree with this—you know, it's easy for Senators and Congressmen, having been on both sides of the government, been in the executive as a mayor, been in the legislative branch. It's much easier in the legislative branch because you can take most any position you want and you don't have any responsibility whatsoever. It's almost like in flying. You're in the left seat and you've got a check pilot over there and he's not flying the airplane, but boy, he can find everything you did wrong. And that's the traditional adversary relationship between the legislative and the executive branch of Government.

I almost think it's too bad that there isn't somebody that could call Senators and Congressmen to a hearing and ask us questions about why we have so badly fouled the fiscal policy of this country. It would be an interesting concept.

Mr. **Weidenbaum**. Can I give you a 10 second answer, because there's enough blame to go along both sides of the aisle, both Houses, both branches. We really haven't at critical times, and it really goes back to the Vietnam war, made the difficult choices.

We say guns and butter. We had guns and butter and fat, literally, if you look at the Federal budget.

Senator **Riegle**. We still do.

Mr. **Weidenbaum**. Yes.

Senator **Riegle**. We still do. It hasn't changed.

Mr. **Weidenbaum**. That's the problem.

Senator **Sarbanes**. But in that context, I welcome your recognition that cutting the revenue base is a budget-buster as well.

Mr. **Weidenbaum**. It's part of the reason that the deficit is as large as it is, no doubt about it.

Senator **Riegle**. You know, Mr. Chairman——

Senator **Sarbanes**. Particularly projected out into the future years.

Mr. **Weidenbaum**. Yes, sir.

Senator Sarbanes. And what you've done is to project a policy that shows large deficits at a time that you're assuming an economy with fairly low unemployment.

Mr. Weidenbaum. With declining unemployment.

Senator Sarbanes. Yes, which is really serious.

Mr. Weidenbaum. And that worries me a great deal.

Senator Sarbanes. Yes, indeed. Yes, indeed.

Senator Riegle. Mr. Chairman, I don't know that this will ever end, but this has been an important discussion.

The Chairman. It will because when you finish, I'm not going to say another word. [Laughter.]

Senator Riegle. You'd better wait on that until you hear what I'm going to say.

You made a good point, I think, Mr. Chairman, about serving in both the executive capacity, as you have, and also in a legislative capacity and how these two things have to try to work together. I served in both parties here in the Congress. I've served as a Republican. I've served as a Democrat. I've served as a Republican under Presidents that were both of my party and the opposite party and I've done so as a Democrat. So I've seen it all four ways from the inside.

I just want to make this observation because it is not understood in terms of the dynamics of how we get out of this trap, this economic trap that we are in at the moment. And that is that we can talk about the Congress taking the lead. There are 10 good reasons why the Congress is not capable of taking the lead and leading the country out of this kind of an economic quandary.

The Chairman. No, 535. [Laughter.]

Senator Riegle. And here is one of the dilemmas that is faced. Take Howard Baker, a man I respect enormously, a leader of the Republicans and of the Senate today because his party is in the majority. Let's leave Tip O'Neill aside. How can Howard Baker, as a practical matter, come in here and in any sweeping way challenge the policies or the spending preferences of an incumbent administration of the same party? It is virtually impossible and I know of no majority leader in recent history that has done it. And I am not saying that Howard Baker should be expected to somehow be different than his predecessors in either party.

But the hard fact of the matter is that the party in power in the White House, having control here in the Senate, leadership of that party is not really free to map out a different economic course that is sharply at odds with the President. As a matter of fact, I think they've gone as far as they can in terms of scaling the deficits down from what the President asked for. You fellows asked for more spending, for bigger deficits. That is just the fact of the matter.

On the House side, you've got Tip O'Neill of the other party nominally in charge, but he is not really. On the key test votes on economics, Tip O'Neill has not been able to deliver the votes for his point of view and the White House has, in fact, been able to deliver the votes for its point of view.

So it is just important to bear in mind the dynamics on the legislative side this time for anybody to say in textbook fashion, why doesn't the Congress lead the country out of this quagmire over both fiscal policy and the contradiction of fiscal and monetary policy. The hard fact of the matter is that the Congress is inherently incapable of doing that right now. I wish that were not the truth. I wish we were able to do it. But we need somebody else and the country needs somebody else. That is, we need the President and the administrative machinery making that kind of an effort.

And if you do not have that, if you have a President or an administration that is serene, that is at peace with what is happening, that thinks that things are going to get better on their own and does not want to go out and lead an effort for a major adjustment in the policy mix, a mid-course correction, it will not occur. It cannot occur. And you do not have to take this from me. You can sit down with the head of any major bank in this country today, any major financial institution, any major corporation that has looked at this thing and they will say precisely what I am saying—that you cannot lead a major adjustment in policy, one, without the President, or two, without the President in front leading that work effort.

I am prepared to work on a bipartisan basis within that kind of work effort, but, my friend, I can't call that meeting, Tip O'Neill can't call it, Howard Baker can't call it, Jake Garn can't call it. No one can call it. The only person that can really put this puzzle together, in a leadership sense, is the person who is the elected leader of the entire country, and that happens to be the President, and you work for him.

I've made my suggestions, but until that step is taken, we are not going to get out of this paralysis that we are in.

Mr. WEIDENBAUM. Let me assure you, when Senator Baker, Senator Garn, the other Republican Senate leaders, come to the White House and meet the President ——

Senator RIEGLE. You have to involve both parties.

Mr. WEIDENBAUM [continuing]. That is a very independent, tough-minded group.

Senator RIEGLE. You have to ask both parties.

Mr. WEIDENBAUM. That makes their views known loud and clear to us. Obviously, no longer being a member of our party, you are not invited to those Republican meetings.

The CHAIRMAN. I could call a meeting and nobody would come.

Senator RIEGLE. I'd come. I'd come, Jake. [Laughter.]

The CHAIRMAN. I'm glad you reserved one final comment for me. A vote is going to get us out of this. That is simply, you are right. A group of 535 people have an almost impossible task to lead. But however bad this budget resolution is, we can, at least, play our part by attempting to meet those budget guidelines in the appropriations process.

Murray, we thank you for coming. And gentlemen, if Mr. Olsen and Mr. Maude would come to the witness table—we do have a vote. I will go and return as rapidly as I can and stay as long as necessary so that we can hear your testimony.

The committee will stand in recess for 15 minutes. [Recess.]

The CHAIRMAN. The committee will come to order. Mr. Olsen, in utter frustration, probably went out into the hall.

Mr. Maude, why don't you go ahead and start and I am sure he will return quickly.

STATEMENT OF DONALD E. MAUDE, CHIEF FINANCIAL ECONOMIST AND CHAIRMAN, INTEREST RATE POLICY COMMITTEE, FINANCIAL ECONOMIC RESEARCH DEPARTMENT, MERRILL LYNCH, PIERCE, FENNER & SMITH

Mr. **Maude**. I want to first of all apologize, Mr. Chairman. We had 80 copies of this sent down by Federal Express. They received it yesterday morning. The courier got it and did not believe that this was the correct address and never delivered it, and we are still trying to track it down.

I think I did manage to have 8 copies sent down. I think you've got a copy and Senator Riegle does, too. Because I did not have enough copies to pass out, I had wanted to just very briefly summarize this, but this won't take more than 10 minutes. I think it would be appropriate for me to read through it because many other people in the room do not have a copy.

[The complete statement follows:]

Summary of Statement Made By

Donald E. Maude

Chief Financial Economist

Chairman, Interest Rate Policy Committee

Merrill Lynch

I am indeed pleased to have the opportunity to testify before this Committee on the occasion of the semi-annual Humphrey-Hawkins hearings on Federal Reserve policy and at a time when the spotlight has temporarily shifted from the fiscal to the monetary sphere. Obviously, given the importance of monetary policy to our nation's future economic direction and as one whose vocation it is to scrutinize the Fed's activities on a day-to-day--and sometimes on an hour-to-hour--basis, I can appreciate the importance of such semi-annual reviews of policy. In this spirit, my remarks this morning will be confined to the state and conduct of monetary policy. However, I cannot emphasize sufficiently the importance of fiscal policy and the role that prospective huge budgetary deficits over the years ahead will play in determining the direction of interest rates and our future economic health. No alteration in the way the Fed conducts policy on the monetary side--no matter how dramatic it may be--can pave the way for sustained lower interest rates and vigorous economic recovery in the absence of a major resolution on the fiscal side.

At the outset, I would like to provide my broad view on the conduct of monetary policy under the stewardship of Federal Reserve Board Chairman Paul Volcker. After more than a decade of misguided monetary policies that culminated in a worldwide wave of inflationary psychology, a massive attack on the dollar in the foreign exchange markets, a flight from financial to real assets and a total destruction in the Central Bank's credibility, Chairman Volcker has almost single-handedly reversed the tide. Under his leadership, the Fed has remained the only anti-inflation game in town.

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Through perseverance and determination in sticking to course, he has regained in two years the anti-inflation resolve credibility that had increasingly been in a state of erosion throughout the 1970's. Of course, in the process, substantial costs have been incurred. It would be sad indeed if one of those costs turns out to be the Central Bank's loss of independence from the political arena. Were the Fed to find its independence relinquished, there would be no game in town at all. Furthermore, I can assure you that even any slight hint of such a possibility would send the financial markets in a total state of chaos and interest rates soaring to new heights.

This is not to say, however, that the Fed's conduct of policy since the appointment of Chairman Volcker and the inception of a more monetarist doctrine of reserve targeting in October 1979 has been impeccable and that there is no need for some adjustments in policy implementation. Indeed, it has been anything but perfect and some adjustments in implementation and monetary aggregate definitions are not only appropriate, but mandatory in my view. An elaboration of my observations along these lines will provide the thrust of my testimony.

The Setting . . .

I need not elaborate here on the dismal economic performance that has transpired since the adoption of the Fed's new operating procedures in late 1979. (A more detailed articulation was put forth in a speech I made to The National Press Club back in May and which I submit for the record.) Suffice it to point out that the U.S. economy has experienced no real growth and declining production since the end of 1979--a performance unprecedented over the postwar period. In addition, the unemployment rate, as all of you well know, stands at a new postwar high, the auto, housing and capital spending sectors remain strangled by stratospheric real rates of interest and bank-

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ruptcies continue to mount at an alarming pace. Corporate balance sheets are seriously strained, savings and loan associations, in the main, are paying more for money than they are earning on assets and experiencing a drain on capital with each passing day, commercial banks are exceedingly tight and state and local governments are increasingly seeing surpluses dwindle--or even turning into deficits. In short, we have a serious liquidity problem on our hands.

I point out these developments not to play the role of an alarmist. I merely suggest that some pieces of the economic-financial-monetary puzzle have to be missing. This would especially appear to be the case since these difficulties have been intensifying rapidly over the first half of this year when stated M-1 and M-2 growth was running well in excess of the upper end of the Fed's targets, thus forcing a restrictive monetary policy. In effect, on the one hand, economic, financial and interest rate developments suggest to me that the Fed has been overly restrictive. On the other hand, the monetary aggregates--as officially defined--suggest to me that the Fed has been overly accommodative. Somehow, one would think that the reconciliation of such an anomaly would receive the highest of priorities.

Possible Reconciliation . . .

It is my judgment that the true stance of monetary policy is more accurately reflected by the dismal state of the economy, severely strained liquidity in the corporate sector and financial system and historically high real rates of interest than by stated monetary aggregate growth thus far this year. As such, the Fed, in chasing after monetary targets in order to sustain credibility in the credit markets, has been pursuing an unduly restrictive course. Under such circumstances, one could make a valid case for a more accommodative policy than is presently in place.

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I am very much aware that this statement represents music to your collective ears. However, before you turn up the volume, it should be emphasized that any accommodation on the part of the Fed should have as a prerequisite further tightening on the expenditure side of the fiscal side. Otherwise, any relief from monetary accommodation will be short-lived. Indeed, I am sure that Chairman Volcker has considered the possibility that such accommodation--if it served to take the edge off of the urgency to take more responsible measures on the fiscal side--could very well backfire and exacerbate the situation. Convincing the Chairman that this would not be the case--by actions, not by words--might go a long way in reaching the fiscal-monetary detente so urgently needed.

M-1, Not What It Is Supposed To Be Or Has Been. Without getting technical to any large degree here, it is my view that the M-1 that has been growing way above targets and forcing a restrictive policy thus far this year is not a valid measure of what it has gauged through the years. Technically, M-1 is supposed to measure the level of "transactional" (or readily spendable) deposits and currency in the system. It is not supposed to include savings-type deposits or balances being built up for precautionary reasons. In the past, M-1 served its purpose well. However, with historically high interest rates and resulting financial innovations over the years, its ability to capture strictly transactional balances and to exclude savings balances has diminished significantly.

In this regard, as you know, banks were allowed to introduce nationwide NOW accounts beginning in January 1981. With the knowledge that some of the increase in such accounts would come from savings accounts and would not represent transactional balances, the Fed utilized a "shift-adjusted" M-1B measure last year to more accurately reflect what was going on with spendable balances. This adjustment was dropped in December, though, and since then all "other checkable" deposits have been defined as "transactional" in nature. As the following table shows, the Fed's own survey assumed that as recently as October of last year, fully one-half of the increase in these deposits was coming from savings accounts--and should not be included in the targeted M-1 measure. In November, the shift from savings accounts declined to 22.6% and in December it rose to 30.4%. With the slowdown in the growth in other checkable deposits from May to October, it does seem reasonable to assume that the dollar magnitude of such shifting had diminished significantly. By way of example, after drawing $9.5 billion out of savings accounts from January to April, NOW accounts subsequently only pulled an additional $1.0 billion from savings accounts from April to the end of October.

However, since October, these deposits have surged by $18.3 billion--accounting for 91% of the M-1 increase. Certainly, it would seem reasonable to me that this surge indicated that shifting from savings accounts had resumed. Yet, for some unexplainable reason, the Fed stopped making such adjustments after December. Had they continued to use such a measure, M-1 growth in June would have been 0.7% below the upper end of target--not 0.1% above. This estimate is based upon the assumption that only 24% of the growth in NOW accounts was coming from savings--the average percentage of shifts in 1981. I suspect that even a larger proportion emanated from non-transactional sources. (The analytical underpinnings for such a view, articulated in the attached January 29 edition of the WEEKLY CREDIT MARKET BULLETIN, is submitted for the record.)

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In addition to capturing non-transactional savings-type deposits, there is reason to suspect that the stated M-1 measure has included non-transactional "precautionary" balances as well--especially over the November-January period. Such balances, of course, should not be included in M-1 (and have not in the past). Indeed, the buildup of these balances was due to economic weakness--not economic strength. (For the record, in this regard, I have included the February 5 edition of the WEEKLY CREDIT MARKET BULLETIN.)

Monthly Changes In M1-B

	M-1 Change	Shift Adj. M1-B Change	Other Check. Change	Amount of Other Check. From S.D.	% Increase in NOW Accounts Rep. Savings Deposits
1981--					
Jan.	3.4	- 0.1	16.3	3.5	21.5%
Feb.	1.5	- 1.0	10.1	2.5	24.8
March	5.0	3.4	6.2	1.6	25.8
April	8.9	6.8	7.0	1.9	27.1
May	- 4.1	- 3.5	- 1.3	(0.6)	(46.2)
June	- 0.8	- 1.3	1.5	0.5	33.3
July	0.9	0.7	1.3	0.2	15.4
Aug.	1.6	1.3	1.4	0.3	21.4
Sept.	0.3	- 0.1	1.8	0.4	22.[illegible]
Oct.	1.7	1.5	0.4	0.2	50.0
Nov.	3.5	2.8	3.1	0.7	22.6
Dec.	4.4	3.7	2.3	0.7	30.4
1981 Total:	26.3	14.2	50.1	11.9	23.8
1982--					
Jan.	7.7	6.7	4.1	1.0	23.8
Feb.	- 1.3	- 0.7	2.7	0.6	23.8
March	1.0	0.4	1.9	0.5	23.8
April	4.0	3.7	2.9	0.7	23.8
May	- 0.8	- 1.2	- 1.6	(0.4)	23.8
June	- 0.5	- 0.4	0.3	0.1	23.8
1982 Total:	10.1	8.5	10.3	2.5	

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M-2, Not What It Is Supposed To Be Or Has Been. Another force keeping the Fed on a restrictive course has been above-target growth in M-2. Indeed, such rapid growth forced the Fed to remain tight last spring even when M-1 growth was well below target. However, M-2 today is not what it was in the past. (In this regard, I have attached for the record an analysis of the problem with M-2 that was done in the CREDIT MARKET DIGEST last September.) In short, what the analysis argues is that M-2 growth has been overly stated by historically high interest rates and the growing proportion of its components earning market rates of interest. These two factors did not exist in the 1960's and early 1970's. In effect, as high interest is credited to the M-2 components, it represents a transfer of funds from borrower to deposits included in M-2--not newly created money by the Fed or enhanced overall liquidity.

While the analysis is too lengthy to detail at this time, the following table should make my point clear. In it, I have presented the actual M-2 level for each of the past nine years and the first two quarters of this year along with the annual dollar amount of increase. In column three, I have computed the amount of the M-2 growth that stemmed from interest credited (on the assumption that interest was reinvested in the initial deposit). After subtraction of interest is indicated in column four--the actual net new increase in M-2 (theoretically due to Federal Reserve policy). As can be seen in the final two columns, stated M-2 growth (which includes interest credited and net new increases in M-2) was 8.3% in 1980, 9.8% in 1981 and roughly 9.6% over the first half of this year. However, if we net out interest, we find that "interest-adjusted M-2" rose by a mere 2.0% in 1980, 1.7% last year and roughly 1.9% over the first half of this year. Such weak growth over the period, as reflected in the adjusted measure, would seem more

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in sync with the economic and financial situation that has prevailed over that period of time.

M-2 Growth Before and After Adjustment For Interest Credited

	M-2	M-2 Incr.	Interest Credited	Int. Adj. M-2 Incr.	Int. Adj. M-2	Int. Adj. M-2 Growth	Stated M-2 Growth
1974	890.0						
1975	973.9	83.9	42.8	41.1	931.1	4.6	9.4
1976	1101.8	127.9	50.0	77.9	1009.0	8.4	13.1
1977	1244.5	142.7	55.9	86.8	1095.8	8.6	13.0
1978	1354.3	109.8	63.2	46.6	1142.4	4.3	8.8
1979	1469.9	115.6	79.5	36.1	1178.5	3.2	8.5
1980	1591.7	121.8	98.0	23.8	1202.3	2.0	8.3
1981	1747.3	155.6	135.0	20.6	1222.9	1.7	9.8
1982							
I Qtr.	1851.5	176.4	148.0	28.4	1251.3	2.2	9.8
II Qtr.	1894.9	173.6	155.0	18.6	1269.9	1.5	9.4

In summary on the foregoing points, it is my view that if the appropriate adjustments to make M-1 and M-2 consistent with what they were in the past were made (namely transactions balances and primarily net new savings and time deposits), we would find that both have been growing below targets for some time now. It is curious that the Fed has not deemed such an approach appropriate under the circumstances.

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Certainly, the stated rapid M-1 and M-2 growth since October of last year does not seem consistent with the Fed's reserve posture over the same period. From November to June, for example, nonborrowed reserves have grown at a mere 3.4% annual rate and total reserves at a 5.7% annual rate. Generally, these are not reserve growth rates that produce rapid money growth. Let me make it quite clear, though, that I am not advocating a cave in by the Fed for political expediency. Accommodation motivated by this consideration would be disastrous. I am advocating accommodation on pure fundamental economic, monetary and financial grounds.

Monetary Policy Conduct Considerations . . .

1) Refine M-1 measure to net out savings-type and transactional balances and use an interest-adjusted M-2 measure.

2) Continue following a policy geared to the consideration of both M-1 and M-2 (do not just slavishly target and respond to one aggregate) and do so in the context of bank credit growth. If bank credit growth is modest and M-1 and M-2 growth rapid, for example, the monetary aggregates should play a diminished role in policy formulation and vice versa.

3) Eliminate "base drift" from annual targeting. Targets for each succeeding year should be based upon the midpoint M-1 and M-2 levels of the present year's targets (for more detailed analysis, see attached edition of the May 21 WEEKLY CREDIT MARKET BULLETIN). Had this been done for this year's targets, M-1 growth thus far would have been below the lower end of the 2-1/2% to 5-1/2% range.

4) Smooth out the roller-coaster movements in nonborrowed reserve growth. Such a roller-coaster course can be seen from the following graph. As can be seen, the roller-coaster reserve growth has been matched by roller-coaster M-1 growth.

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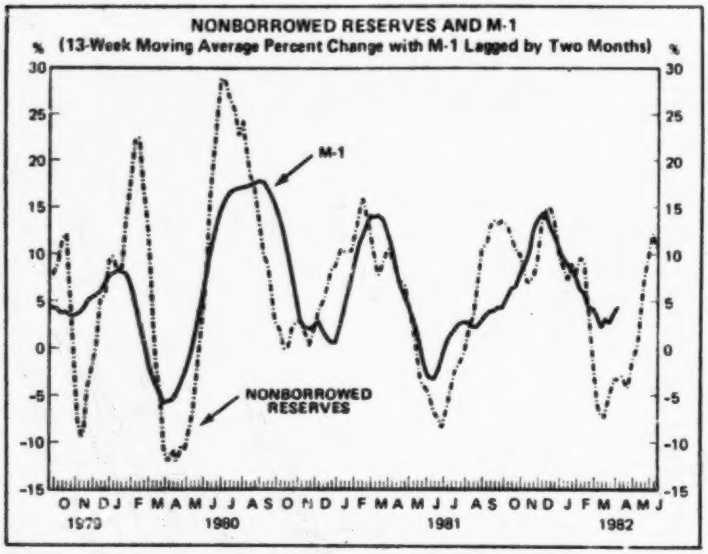

NONBORROWED RESERVES AND M-1

(13-Week Moving Average Percent Change with M-1 Lagged by Two Months)

5) Immediately institute the proposed practice of publishing the monetary statistics (M-1) on a four-week moving average basis to smooth out the week-to-week "noise."

6) Key the discount rate to a level 2% to 3% above the twelve-month moving average rate of inflation as measured by the personal consumption deflator. This would be changed each month with inflation. As such, an easing of rates would occur during decelerating inflation and rising rates during accelerating inflation and act as an automatic stabilizer.

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Remarks by

Donald E. Maude

Chief Financial Economist
Chairman, Interest Rate Policy Committee
Merrill Lynch

May 5, 1982

I. The Setting . . .

The battle of the budget continues to ebb and flow here in Washington as political positioning between the Democrats and Republicans, in anticipation of the summer campaign and autumn elections, appears to be the order of the day—and the key motivating force. The Democrats, on one hand, seem to feel no urgency to make tough and politically unpopular decisions that could alleviate the budgetary deficit logjam on interest rates and economic recovery. Indeed, as things stand right now, they seem to be basking in the enviable position of entering the campaign against an opposition party and incumbent administration whose economic recovery program thus far has turned out to be a total failure. The Republicans, on the other hand, have appeared more conciliatory in the budget deliberations as they, too, seem to sense that failure to deliver their program's promise for declining interest rates and brisk economic recovery could be devastating to chances of victory in November. ***In effect, the budget appears to have become a political tennis ball, moving from court to court with the participants' primary goal being the determination of the political affiliation of winners and losers in November.***

Unfortunately, the real winners and losers from the outcome of this volley will not be those residing on this side of the Potomac. Instead, it will be those working on Wall Street and residing on Main Street across the nation. Indeed, presently at stake is no less than the very survival of key industries and financial institutions that are so critically needed to sustain the American system of capitalism. It is indeed a pity and a clear and present danger to the nation's financial fabric that these latter economic and financial considerations have apparently continued to take a back seat to political maneuvering in the all-important and critical battle of the budget.

To some, of course, this would appear to be an overdramatization of the situation and a myopic obsession with budgetary deficits that should be taken with a grain of salt as coming from one subjected to day-to-day shattering on the battlefield of the bond and money markets—and having a Keynesian-oriented training to boot. Obviously, this might preclude one's ability to step back and see the clearer "big picture". After all, everyone including the President has told us that deficits really do not matter that much. To the monetarists, there is nothing wrong with the financial markets that could not be rectified by a credible monetary policy. To many in

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the administration, the heart of the problem has been a monetary policy that produces erratic week to week movements in the money supply—not deficits. Smooth out money supply growth and all the financial markets' problems will go away. To the supply siders, rates would plummet and the economy would enter into a sustained period of brisk economic growth in a noninflationary environment if only we would return to the good old days of the gold standard. To some in Congress, the problem of high interest rates does not lie with their failure to further cut expenditures, but with Paul Volcker. Replace the Fed Chairman and the financial markets' problems would disappear.

Others, such as Arthur Laffer, would say that nothing has to be done. Just give the President's program time to work. The "real" part of the program in the form of a full 10% tax reduction has not even taken effect yet. When it does, there will be a surge in private savings and consumer spending—both at the same time—and from a tax cut that will be spread over a year's time, mind you, that will boost the economy and allow the fiscal 1983 deficit to be financed smoothly in a declining interest rate environment. In fact, this scenario seems to be the consensus forecast among most private economists.

Many political analysts as well would adhere to such a scenario. ***After all, this is a critical off-Presidential election year in which the incumbent administration needs to maintain most—or all—current Republican representation in order to further carry out its program. It will do everything in its power to engineer an environment of declining interest rates, rapid economic growth and declining unemployment and a moderate rate of inflation.*** The same, of course, was true during the off-Presidential election year of the first Nixon Administration in 1970. However, that year witnessed the fifth postwar recession, a 51% increase in the unemployment rate and an unthinkable 4.8% annual rate of increase in consumer prices—the second largest yearly gain over the postwar period. The next major Congressional election year came in 1974—a period during which the nation experienced double-digit inflation, historic highs in interest rates and the steepest recession of the postwar period. The 1976 Presidential election year saw an economic "pause" that many feel helped lead to the defeat of President Ford. In the 1978 election year, the Carter Administration did manage to stave off a recession, but only at the cost of fostering policy moves that led to a total destruction of credibility in the international financial markets and the need to sharply boost interest rates with a dollar support package just four days prior to the election. And need one elaborate about the environment during the 1980 Presidential election year of recession, double-digit inflation and sharply rising interest rates during the summer campaign and autumn election period. ***From this recent history of election year economic and financial environments, it becomes quite clear that Murphy's Law is still alive and well.***

II. Where We Presently Stand—The Stark Realities . . .

While the economy remains quagmired in its eighth postwar recession, it is becoming increasingly clear that the worst is behind us. With the recession now some ten months old, it is likely that economic recovery is just around the corner. After all, postwar business cycle history shows that the average duration of recessions has generally been around eleven months. What is more, the depth of the present recession in terms of contraction in both broad and narrow economic measures is about comparable to previous recessions. At the same time, the nation has benefited from a dramatic deceleration in inflation. Indeed, producer prices have declined for two consecutive months and consumer prices in March posted their first decline in seventeen years. Certainly, these considerations do not paint an ominous picture by any means.

However, the recent recession must be viewed against a backdrop of economic levels from which it started. It came on the heels of a rather anemic and short-lived, one-year expansion subsequent to the 1980 recession—an unprecedented development. ***Instead of contracting from expansion peak levels of activity, the economy began contracting from close to trough levels. As a result, I would offer the following quite sobering observations:***

. . . In the Economy, ***since the end of 1972, real GNP has actually declined by 0.3%. This decline over a ten-quarter span is unprecedented in our postwar history, which has seen real GNP expand at an average annual rate of 3.5%.*** The lost real output since the end of 1979—the difference between historical experience and actual results—comes to a whopping $127.3 billion. Industrial production stands more than 9% lower than at the end of 1979 and the degree of idleness in the nation's factories is flirting with a postwar record. Not surprisingly, in the process corporate profits have plunged by a whopping 31% since early 1980—on an after-tax basis.

Business failures are up 92% since 1979 and are flirting with depression levels. What's more, the size of current liabilities of such failures have more than doubled over the same period.

The consumer sector as well does not have much to cheer about. Wages and salaries in real terms, for example, are 7.3% lower now than in early 1980 and the savings rate remains at historically low proportions. Consumer confidence is now at the lowest level since the Conference Board began recording the pulse of sentiment, and buying plans continue on the decline. The value of consumers' home equity has stopped going up and has actually posted a slight deterioration since last August. The unemployment rate is now at a postwar record of 9.4% and, if one includes "discouraged workers", it is close to 13%. Mortgage loan delinquencies at the savings and loan associations are some 27% higher than in early 1980.

Add to this the fact that new home sales are at a postwar record low, housing starts have run below one million units for eight consecutive months—the longest sustained period of starts running below this benchmark level—auto sales are close to postwar lows even at a time when major promotional programs have been in place, International Harvester, the plight of the airlines, the trucking industry and farmers and ***it is quite difficult to celebrate about the fact that recovery may be around the corner.***

. . . In the Corporate Sector, ***balance sheets are in the worst state of health ever.*** Even in the face of sharp inventory liquidations and capital spending paring, capital expenditures are still outpacing internal cash flow by 13% at a time of severe profit squeeze. The failure of the bond market to open up for sustained periods of time has made nonfinancial corporate balance sheets laden with short-term debt. During the fourth quarter of last year, for example, the ratio of short-term to total credit market debt stood at a record 42%. Throughout the 1950's and 1960's, this ratio ranged between 26% and 30%. It was considered alarming in the mid-1970's when it moved up to the mid-30% area. Available liquid resources are at alarmingly low proportions. Liquid assets as a percent of total financial assets, for example, stood at a meager 19% during the fourth quarter of last year. In the 1950's, this ratio was as high as 50%. In the 1960's, concern was expressed on the corporate sector's ability to meet current bills from liquidity. Liquid assets as a percentage of current liabilities was in the 60% area in the 1950's and the 40%-50% range in the 1960's. Now, it stands at 22%.

With such a financial state, it is little wonder that many corporations have been precluded from raising funds in the capital market and have placed the burden on the banking system. The interest servicing burden on corporations alone is eating up almost 50% of internal cash flow. Back in the 1960's, it was less than 10%. ***This has obviously kept the rating agencies—Moody's and Standard and Poor's—burning the midnight oil.*** Thus far this year, for example, of the accelerating pace of rating changes that have taken place, more than two-thirds have represented downgradings.

. . . **In the Financial System, *even the average citizen on Main Street is familiar with the plight of the S&L's.*** Net of interest credited, they have only experienced inflows in two out of the last thirteen months (October and February). Last year the S&L's experienced a $4.6 billion erosion in capital and fully 85% of such institutions are losing money every day they open for business as the return on assets is now falling short of the cost of funds by 1 1/2%. Unless a sharp decline in rates ensues, the spread threatens to get still wider. ***Even with a sharp and sustained decline in rates—a highly unlikely event—almost 800 more S&L's will be operating with no capital by the end of 1982.*** It is because of this that forced mergers by the Authorities are on a sharply accelerating track. Certainly, given the current situation, the relatively meager $6.3 billion reserve held by the Federal Savings and Loan Insurance Corporation does not offer one great solace.

While the commercial banks have avoided the type of plight experienced by the thrifts, they have not come away unscathed. ***Given the dismal state of the corporate sector and international problems that have surfaced, problem or nonperforming loans have continued on the ascent and remain at exceedingly high levels—a highly atypical development during a recession.*** Over the past eight years or so, the banks' equity to asset ratio has declined by almost 16%. ***In short, bank balance sheets give the appearance that we are at the peak stage of an economic expansion—not the trough of a recession.*** The banking system, given continued strong loan demand by corporations an an exceedingly stringent reserve policy by the Fed, has yet to rebuild its balance sheet. ***No wonder, all but one of the top ten banks in the nation have had ratings lowered on their senior debt.***

. . . **State and Local Government, *as well are severely feeling the pinch from combined recession and exceedingly high interest rates.*** By the end of this year more than half the states will be operating with surplusses below the critical 5% level. In about fifteen states, actual deficits will be posted. Services have been scaled back and many states are increasingly looking for increased revenues through taxation. Keep in mind, these states are just now beginning to feel the squeeze from budget cuts on the Federal level. This is occurring at a time when many states are not allowed to go to the capital markets at current interest rates and many localities incur the risk of downgrading of ratings.

. . . **In the Farm Sector,** ***the very cornerstone of the American economy, a plight not witnessed since the Great Depression is in progress.*** In real terms, for example, net farm income plunged from $17.7 billion in 1974 to $8.7 billion in the fourth quarter of 1981. Squeezed by weak crop and livestock prices, costly machinery and prohibitively high interest rates, many farmers now find mortgages at the risk of foreclosure. Those who have been forced to liquidate have had to settle for 50 cents on the dollar. Many farmers find income as low as during the Great Depression. Certainly, given the state of the manufacturing sector, it is difficult to say how these beleaguered farms can be absorbed elsewhere into the economy. Unfortunately, as long as rates merely stay where they are, this plight will heighten over the months ahead. Already we have seen the repercussions of this situation on the budgetary deficit as it has had to be enlarged in response to the initiation of recent price supports.

And with all of this abounding all around us because of the two-pronged pinch of a recession and exceedingly high interest rates, one still gets the impression that a good portion of the budget battle is political in nature and that an eleventh hour sense of urgency just does not exist.

III. Where We Go From Here . . .

Certainly, given the preceding considerations one would hope that there is nowhere for the economy to go from here but up. At the same time, one would hope that the only place interest rates could go from present real levels, not witnessed since the Great Depression, would be down. While some degree of confidence can be attached to the former, the same cannot be said about the latter.

Looking at the matter in greater detail is our view that the reliquefication of the consumer sector with respect to debt-to-income ratios and the final workoff of unwanted inventories during the first quarter and on into the spring months are in the process of sowing the seeds for economic recovery during the summer months. Such seeds, of course, will be fertilized with the July 1 enactment of the 10% tax cut and Social Security benefit cost of living increase. The key question that one must ask, however, is how sustainable will such a recovery be. The key here, of course, lies in the interest rate outlook.

With further paring in capital spending, inventory reduction and a moderation in money supply growth in May and June, it most certainly is probable that recent upward pressures on interest rates will abate quite modestly. Unfortunately, such a tranquil environment in the financial markets will probably further reduce the sense of urgency in Washington to make the hard choices that are required to materially reduce prospective budgetary deficits. This is quite disconcerting since the spring tranquility should shift to a summer eruption in the financial markets. As we shift from spring to summer, there will indeed be signs that the economic recovery is in the process of unfolding. Unfortunately, this will probably give the markets the worst of both worlds. On the one hand, the recovery will be strong enough to impart a negative psychological tone on the credit markets and possibly rekindle fears of crowding out. On the other hand, though,it will not be sufficiently robust to meaningfully boost internal corporate cash flow—an event that normally is counted upon to alleviate short-term borrowing needs. At the same time, the markets and the Fed will have to brace themselves for a potential major explosion in money supply growth in early July. As was the case in April, some of this growth will be related to technical phenomena and faulty seasonal adjustment factors. Unlike the April bulge, however, it will also be predicated upon fundamental grounds as the economy is in the process of recovery, the 10% tax cut goes into effect and the cost of living increase in Social Security benefits will be providing an infusion of real spendable money into the system. Given the likelihood that money supply growth will be well in excess of targets going into July, the Fed will have no choice but to forcefully tighten policy. The story does not end here. As we shift from the second to the third quarter, the Treasury's net new cash needs will be in the process of tripling—from about $14 billion in the second quarter to $40 to $45 billion in the third quarter. Add on top of this actual financing pressure the fact that the OMB's "Mid-Season Review" places projected budgetary deficits for fiscal 1983 well into the triple-digit territory and the ingredients for retesting the old highs in long-term rates will be firmly in place. It is during this period that some commercial paper issuers may be forced out of the market into the banking system and long-term issuers may decide to "throw in the towel" in order to access the availability of funds at any price.

Quite obviously, we are slowly building the foundation for a potential major crisis environment during the summer months. One can only hope that such an environment will represent sufficient encouragement to the Administration and Congress to take major initiatives toward making the hard choices that would materially reduce looming budgetary deficits ahead. If in fact these initiatives are taken, the summer pressure in the financial markets can lead to an autumn respite. If indeed such initiatives are genuine, meaningful and credible to the financial markets, the road could be paved for a continuation of a more-than-cyclical deceleration in inflation and a sustained decline in interest rates to inflation-adjusted levels that bear a more realistic semblance of underlying fundamental realities.

The fate of interest rates, the future economic contour and the success or failure of the Economic Recovery Program, therefore, rests here in Washington—not several hundred miles north in Wall Street.

IV. Is the Present Quagmire Intractable?

Certainly, one cannot take a great deal of heart from the present situation and events that are likely to unfold over the quarters immediately ahead. ***We seem to be stuck within a vicious cycle in which large budget deficits and historically high real rates of interest beget weaker economic performance, which beget still higher deficits and, in turn, higher real rates of interest.*** On the monetary front, a Federal Reserve policy designed to bring down interest rates at the expense of excessive reserve growth would initially foster economic growth and would allow Federal deficits to recede in the short run. However, a policy fostering excessive money growth would ultimately lead to accelerating inflation—possibly to new peak rates, an economic recession and growing budgetary deficits. On the other hand, a responsible monetary policy geared to gradually reduce the rate of growth in money at a time when Treasury financing needs are huge would require sufficiently high real rates of interest to keep private corporate borrowing in the capital markets at a minimum. This, in turn, would lead to diminished capital spending and dismal productivity growth which might ultimately lead to accelerating inflation.

This is not to say, though, that the potential for a rosier future does not exist. Just think of what has transpired over the past several years. Inflationary psychology and behavior has been broken to the quick. The commodity price bubble has burst. The price of gold is less than half its level of 1980. Silver has taken even more of a pounding. Masses that were running out of financial assets into real assets, collectables, etc., are now reverting back to more productive forms of investment. The speculative housing bubble has been pierced. Labor, far from placing as their major priority the practice of keeping up with inflation, is now willing to take pay cuts just to maintain the present working status. The previous worldwide oil shortage has turned into a glut, seriously jeopardizing OPEC's clout in influencing economic and financial events around the world. The Administration is desperately attempting to reverse the trend of accelerating Federal Government expenditures. And, last but certainly not least, the monetary authorities have achieved impressive success in reducing the year-over-year rate of growth in money supply for three consecutive years now.

Certainly, forces toward disinflation have been more dramatic than one could have hoped for just one short year ago. Unfortunately, however, there remains one substantial logjam precluding a reversal of the vicious cycle in which we find ourselves. In short, budgetary deficits at the Federal level are out of control. If nothing is done about them, all the gains that we have experienced over the past year or more could evaporate as quickly as they evolved—and all of the severe economic pain and the lost output would have been for nought.

The information set forth herein was obtained from sources which we believe reliable, but we do not guarantee its accuracy. Neither the information, nor any opinion expressed, constitutes a solicitation by us of the purchase or sale of any securities or commodities.

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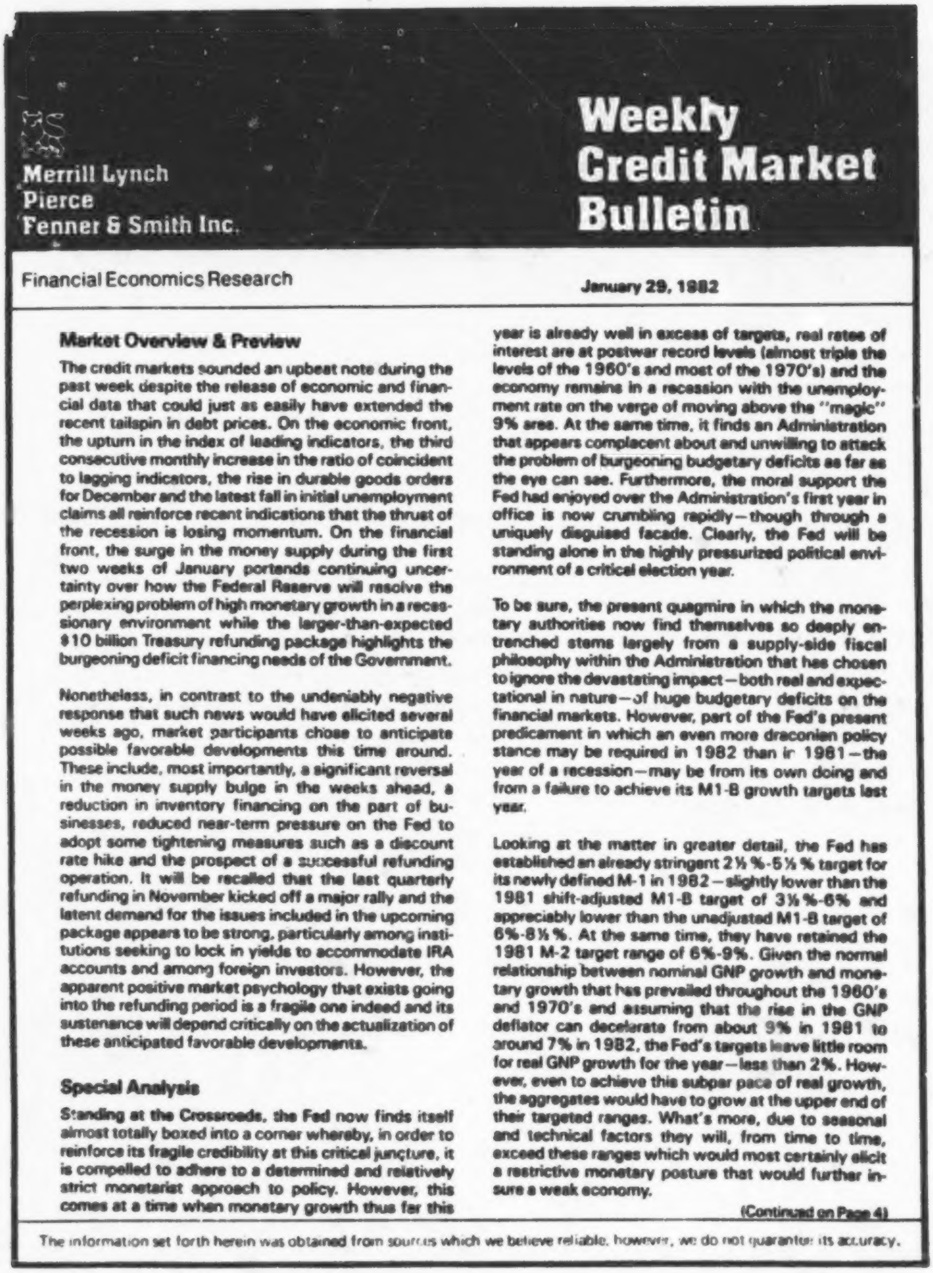

Merrill Lynch
Pierce
Fenner & Smith Inc.

Weekly Credit Market Bulletin

Financial Economics Research

January 29, 1982

Market Overview & Preview

The credit markets sounded an upbeat note during the past week despite the release of economic and financial data that could just as easily have extended the recent tailspin in debt prices. On the economic front, the upturn in the index of leading indicators, the third consecutive monthly increase in the ratio of coincident to lagging indicators, the rise in durable goods orders for December and the latest fall in initial unemployment claims all reinforce recent indications that the thrust of the recession is losing momentum. On the financial front, the surge in the money supply during the first two weeks of January portends continuing uncertainty over how the Federal Reserve will resolve the perplexing problem of high monetary growth in a recessionary environment while the larger-than-expected $10 billion Treasury refunding package highlights the burgeoning deficit financing needs of the Government.

Nonetheless, in contrast to the undeniably negative response that such news would have elicited several weeks ago, market participants chose to anticipate possible favorable developments this time around. These include, most importantly, a significant reversal in the money supply bulge in the weeks ahead, a reduction in inventory financing on the part of businesses, reduced near-term pressure on the Fed to adopt some tightening measures such as a discount rate hike and the prospect of a successful refunding operation. It will be recalled that the last quarterly refunding in November kicked off a major rally and the latent demand for the issues included in the upcoming package appears to be strong, particularly among institutions seeking to lock in yields to accommodate IRA accounts and among foreign investors. However, the apparent positive market psychology that exists going into the refunding period is a fragile one indeed and its sustenance will depend critically on the actualization of these anticipated favorable developments.

Special Analysis

Standing at the Crossroads, the Fed now finds itself almost totally boxed into a corner whereby, in order to reinforce its fragile credibility at this critical juncture, it is compelled to adhere to a determined and relatively strict monetarist approach to policy. However, this comes at a time when monetary growth thus far this year is already well in excess of targets, real rates of interest are at postwar record levels (almost triple the levels of the 1960's and most of the 1970's) and the economy remains in a recession with the unemployment rate on the verge of moving above the "magic" 9% area. At the same time, it finds an Administration that appears complacent about and unwilling to attack the problem of burgeoning budgetary deficits as far as the eye can see. Furthermore, the moral support the Fed had enjoyed over the Administration's first year in office is now crumbling rapidly—though through a uniquely disguised facade. Clearly, the Fed will be standing alone in the highly pressurized political environment of a critical election year.

To be sure, the present quagmire in which the monetary authorities now find themselves so deeply entrenched stems largely from a supply-side fiscal philosophy within the Administration that has chosen to ignore the devastating impact—both real and expectational in nature—of huge budgetary deficits on the financial markets. However, part of the Fed's present predicament in which an even more draconian policy stance may be required in 1982 than in 1981—the year of a recession—may be from its own doing and from a failure to achieve its M1-B growth targets last year.

Looking at the matter in greater detail, the Fed has established an already stringent 2½%-5½% target for its newly defined M-1 in 1982—slightly lower than the 1981 shift-adjusted M1-B target of 3½%-6% and appreciably lower than the unadjusted M1-B target of 6%-8½%. At the same time, they have retained the 1981 M-2 target range of 6%-9%. Given the normal relationship between nominal GNP growth and monetary growth that has prevailed throughout the 1960's and 1970's and assuming that the rise in the GNP deflator can decelerate from about 9% in 1981 to around 7% in 1982, the Fed's targets leave little room for real GNP growth for the year—less than 2%. However, even to achieve this subpar pace of real growth, the aggregates would have to grow at the upper end of their targeted ranges. What's more, due to seasonal and technical factors they will, from time to time, exceed these ranges which would most certainly elicit a restrictive monetary posture that would further insure a weak economy.

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Adding to the problem is the fact that the Fed is calculating its allowable average M-1 level for the fourth quarter of 1982 off of an artificially low fourth-quarter 1981 base. Specifically, with an actual 1981 growth in M1-B of 4.9%, its average level during the 1981 fourth quarter stood at $437.6 billion. However, this average M1-B level fell far short of what it would have been had growth been within its actual targeted range of 6%-8½%. As the following table shows, had the Fed merely achieved M1-B growth at the lower end of its targets, the fourth-quarter 1981 base would have been $442 billion—$4.4 billion higher. Had the Fed hit the midpoint of its targets—presumably the ultimate goal in targeting, the base would have been $447.2 billion—$9.6 billion higher.

In this regard, it is important to note that the maximum allowable 1982 fourth-quarter M1-B level—which would result from upper-end-of-target growth—is a function of the fourth-quarter 1981 base off of which it is calculated. For instance, as the table also shows, had the Fed used the lower end of its 1981 target level as a base, M1-B could average $466.3 billion in the fourth quarter of this year and not exceed the upper end of its 5.5% target. However, using the lower actual base, such a level would represent a rate of growth 1% above the upper target or $4.6 billion. Using the midpoint of the 1981 target as a base, the allowable level of M1-B during the fourth quarter would be $471.8 billion with a 5.5% annual rate of growth. However, such a level off of the actual 1981 base would result in a rate of growth of 7.8%—almost 2½% or $10.1 billion above the upper end of the targets.

In effect, by the use of the below-target 1981 fourth-quarter M1-B level as a base of calculation for 1982, the Fed is compounding its stringency in terms of actual allowable M1-B levels. This is known as negative base drift—in marked contrast to the positive base drift the Fed has enjoyed over the years when actual M1-B growth came in above targets. Just as failure to take into account base drift in setting targets during those periods was criticized as an overly accommodative posture, failure to take into account negative base drift can be criticized as overly restrictive—especially at a time when real high rates of interest prevail and the economy is sluggish at best.

Further compounding the Fed's problem is the fact that it has ceased adjusting M-1 for shifts into other checkable deposits from savings accounts. This would make sense if the level of other checkables had been leveling off for some time, since it would imply that all shifting had reached a conclusion. However, as recently as November, other checkable deposits had increased by $2.8 billion and it was assumed by the Fed that about 32% of the rise stemmed from transfers from savings accounts. As a result, the monthly increase in shift-adjusted M1-B was almost $1 billion less than the increase in unadjusted M1-B. Beginning in December, however, the Fed ceased distinguishing from increases in other checkables emanating from demand and savings deposits and began tracking the old gross M1-B under the new definition of M-1. This is rather curious in light of the fact that other checkable deposits rose again in December—by $2.2 billion—and jumped by a whopping $5.6 billion over the first two weeks of January. Given these jumps in other checkables, we suspect that the Fed has unwittingly bloated the M-1 figures with some balances that are not transactional in nature and has failed to make proper adjustments.

With regard to M-2 as well, it appears the Fed is placing itself in an untenable situation by aiming for a 6%-9% target, given the fact that over 47% of its component is now earning market-related rates of interest. As a result, at least a 7½% rate of growth is already locked in on the basis of interest credited—and not net new creation of savings balances caused by Fed induced money creation. This leaves little leeway for the expansion of transactional balances or of net new savings balances without the Fed seriously overshooting its targets. Given these considerations and the overly restrictive posture the Fed would have to assume in order not to surpass its targets for 1982—with its negative consequences for the economy—it is our view that the Fed should show some flexibility in formulating the fourth-quarter 1981 base to be utilized for target calculations, continue to shift adjust M-1 and make the appropriate interest rate credited adjustment in setting M-2 targets.

THE POTENTIALLY RESTRAINING IMPACT ON FED POLICY OF PRELIMINARY 1982 M-1 GROWTH TARGETS

	IV Q '81 Base	IV Q '81 Base Had Respect. '81 Targets Been Hit	Max. Allow. IV Q '82 Avg. Level	Max. Allow. IV Q '82 Avg. Level Had Respect. Targets Been Hit	Add'l Leeway for IV Q '82 Had Respect. '81 Targets Been Hit
Actual	$437.6		$461.7		
Lower End		$442.0		$466.3	$ 4.6
Midpoint		447.2		471.8	10.1
Upper End		452.4		477.3	15.6

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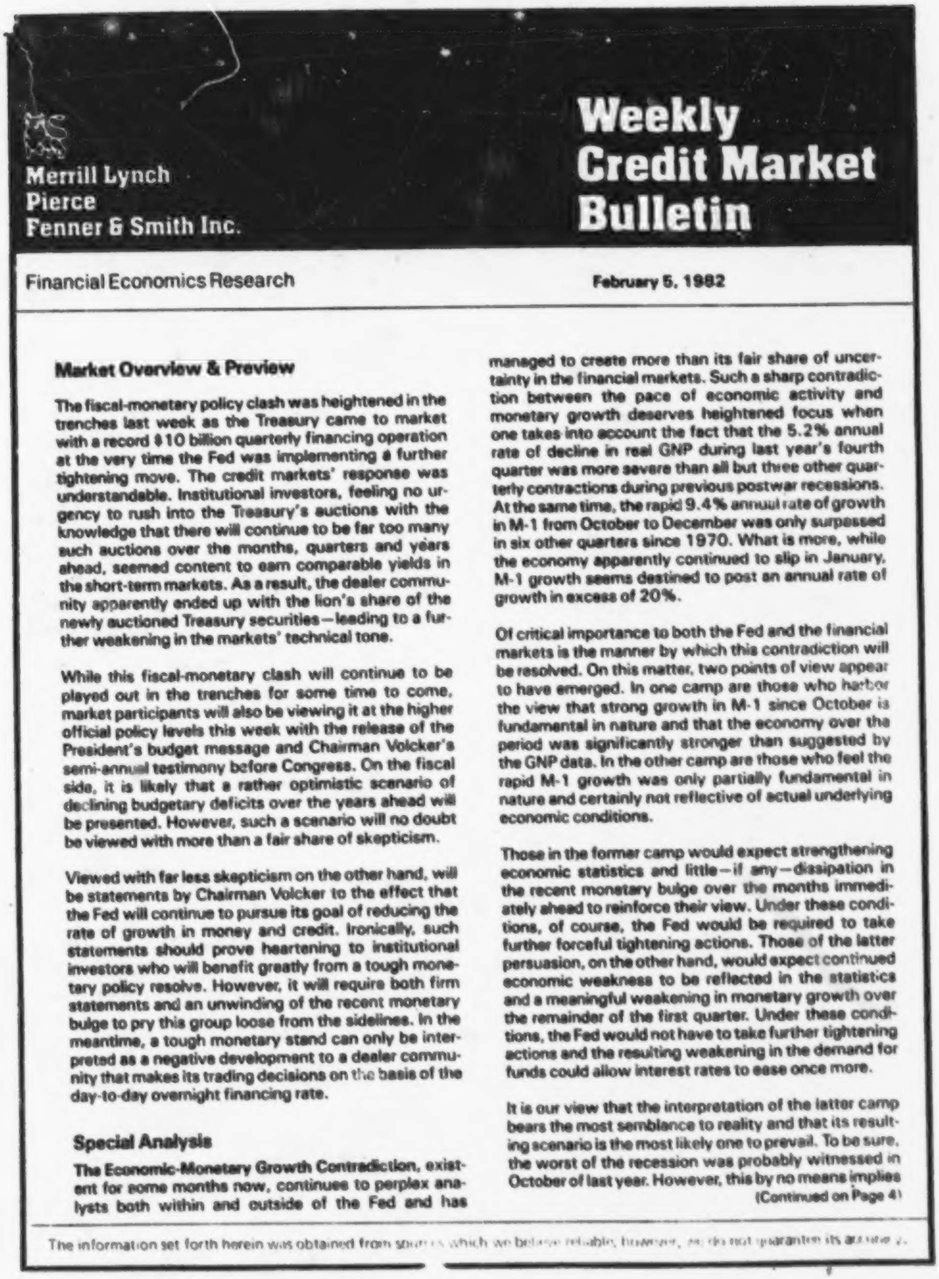

Merrill Lynch
Pierce
Fenner & Smith Inc.

Weekly Credit Market Bulletin

Financial Economics Research

February 5, 1982

Market Overview & Preview

The fiscal-monetary policy clash was heightened in the trenches last week as the Treasury came to market with a record $10 billion quarterly financing operation at the very time the Fed was implementing a further tightening move. The credit markets' response was understandable. Institutional investors, feeling no urgency to rush into the Treasury's auctions with the knowledge that there will continue to be far too many such auctions over the months, quarters and years ahead, seemed content to earn comparable yields in the short-term markets. As a result, the dealer community apparently ended up with the lion's share of the newly auctioned Treasury securities—leading to a further weakening in the markets' technical tone.

While this fiscal-monetary clash will continue to be played out in the trenches for some time to come, market participants will also be viewing it at the higher official policy levels this week with the release of the President's budget message and Chairman Volcker's semi-annual testimony before Congress. On the fiscal side, it is likely that a rather optimistic scenario of declining budgetary deficits over the years ahead will be presented. However, such a scenario will no doubt be viewed with more than a fair share of skepticism.

Viewed with far less skepticism on the other hand, will be statements by Chairman Volcker to the effect that the Fed will continue to pursue its goal of reducing the rate of growth in money and credit. Ironically, such statements should prove heartening to institutional investors who will benefit greatly from a tough monetary policy resolve. However, it will require both firm statements and an unwinding of the recent monetary bulge to pry this group loose from the sidelines. In the meantime, a tough monetary stand can only be interpreted as a negative development to a dealer community that makes its trading decisions on the basis of the day-to-day overnight financing rate.

Special Analysis

The Economic-Monetary Growth Contradiction, existent for some months now, continues to perplex analysts both within and outside of the Fed and has managed to create more than its fair share of uncertainty in the financial markets. Such a sharp contradiction between the pace of economic activity and monetary growth deserves heightened focus when one takes into account the fact that the 5.2% annual rate of decline in real GNP during last year's fourth quarter was more severe than all but three other quarterly contractions during previous postwar recessions. At the same time, the rapid 9.4% annual rate of growth in M-1 from October to December was only surpassed in six other quarters since 1970. What is more, while the economy apparently continued to slip in January, M-1 growth seems destined to post an annual rate of growth in excess of 20%.

Of critical importance to both the Fed and the financial markets is the manner by which this contradiction will be resolved. On this matter, two points of view appear to have emerged. In one camp are those who harbor the view that strong growth in M-1 since October is fundamental in nature and that the economy over the period was significantly stronger than suggested by the GNP data. In the other camp are those who feel the rapid M-1 growth was only partially fundamental in nature and certainly not reflective of actual underlying economic conditions.

Those in the former camp would expect strengthening economic statistics and little—if any—dissipation in the recent monetary bulge over the months immediately ahead to reinforce their view. Under these conditions, of course, the Fed would be required to take further forceful tightening actions. Those of the latter persuasion, on the other hand, would expect continued economic weakness to be reflected in the statistics and a meaningful weakening in monetary growth over the remainder of the first quarter. Under these conditions, the Fed would not have to take further tightening actions and the resulting weakening in the demand for funds could allow interest rates to ease once more.

It is our view that the interpretation of the latter camp bears the most semblance to reality and that its resulting scenario is the most likely one to prevail. To be sure, the worst of the recession was probably witnessed in October of last year. However, this by no means implies

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that the recession is over. The inventory liquidation phase, which brings with it cutbacks in production, rising unemployment and diminished short-term business credit demands, is almost always the last to come—and, indeed, the necessary ingredient paving the way for an ensuing recovery. Admittedly, given the normal lagged impact, there is no question that the Fed's highly aggressive reserve provision over the summer and early autumn months and the sharp decline in interest rates in November did contribute to an acceleration in monetary growth. However, there are several cogent reasons to view the magnitude and nature of growth with a great deal of suspicion.

Specifically, several quite atypical developments in deposit flows in progress since late October might suggest that the dismal economic environment and uncertainty over future employment prospects during November and December—a time when the Conference Board's consumer confidence index plunged by 18%—caused a dramatic surge in precautionary balance preferences. This cautious mood, in turn, seems to have led to the diversion of nontransactional (including certain time deposits and holdings of credit market instruments) funds into M-1 type deposits. Such a diversion of funds could have been further bolstered in January as individuals may have temporarily parked funds in readily accessible deposits until they have had time to better choose among the myriad of Individual Retirement Account programs being advertised in the media.

Perhaps providing an important clue to the desire to build up precautionary balances—even at the expense of some interest income—was the shift in the behavior of time and savings deposits since late October. Specifically, after increasing at an average monthly pace of $8.4 billion from December, 1980 to October, 1981, time deposits (which carry competitive rates of interest, but are not liquid) increased at a monthly rate of $4.2 billion over the November-December period. Savings deposits, on the other hand, had been declining at an average monthly clip of $6.3 billion over the December-October period. However, over the November-December period, these more liquid deposits actually rose by $4.1 billion.

While renewed caution resulted in some shifting among M-2 components, it also probably led to some shifting from M-2 type accounts into M-1. In effect, the dramatic slowdown in time deposit growth probably stemmed from the desire to allow some six-month money market CD's to mature and to place the proceeds in a more liquid savings, NOW or demand account as a precautionary measure. This would appear to be suggested by the 1981 and last month's pattern of "other checkable" deposit growth.

By way of illustration, with the introduction of nationwide NOW accounts last year, other checkable deposits soared by $39.2 billion over the January-April period. From April to October, however, they only increased by $5.6 billion—a $900 million monthly rate. On the other hand, since October they have increased by $11.8 billion—close to a $4.0 billion average monthly pace. Because November was the last month that the Fed distinguished between what portion of the other checkable deposit increase came from demand deposits and what portion came from savings-type deposits, one has to make individual judgment with regards to OCD growth over the last two months.

In this latter regard, it is interesting to note that of the $44.7 billion increase in other checkables from December, 1980 to October, 1981, the Fed assumed that $33.8 billion came from demand deposits. Not coincidentally, over the same period, actual demand deposits posted a $32.7 billion decline—almost an equal offset. Yet, the $11.8 billion increase in other checkables since October came at the same time that demand deposits rose by $5.3 billion. Even more noteworthy is the fact that $7.5 billion of the other checkable deposit increase came over the first three weeks in January—a time when one could reasonably assume savings-type money was temporarily being parked prior to making an IRA account decision. Under the Fed's new M-1 definition, though, these would be classified as transactional balances—a rather questionable procedure.

Given the preceding considerations, therefore, it is our view that some of the recent M-1 strength stems from economic weakness—not strength—and a temporary parking of savings-type funds in NOW accounts. As such, it is likely that the Fed's response to the monetary surge will be a great deal more restrained than would have been the case in other periods of excessive M-1 growth.

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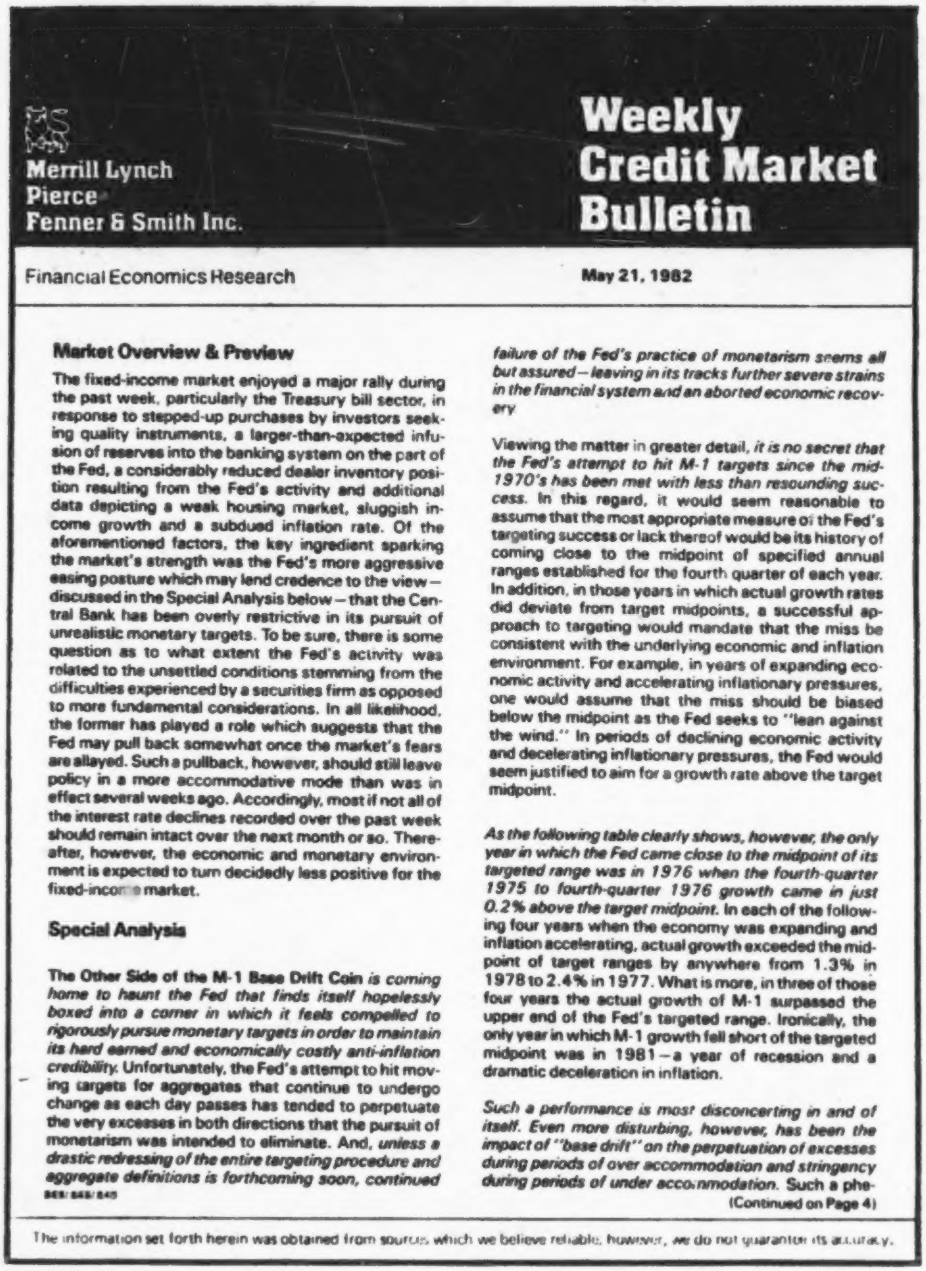

Merrill Lynch
Pierce
Fenner & Smith Inc.

Weekly Credit Market Bulletin

Financial Economics Research

May 21, 1982

Market Overview & Preview

The fixed-income market enjoyed a major rally during the past week, particularly the Treasury bill sector, in response to stepped-up purchases by investors seeking quality instruments, a larger-than-expected infusion of reserves into the banking system on the part of the Fed, a considerably reduced dealer inventory position resulting from the Fed's activity and additional data depicting a weak housing market, sluggish income growth and a subdued inflation rate. Of the aforementioned factors, the key ingredient sparking the market's strength was the Fed's more aggressive easing posture which may lend credence to the view—discussed in the Special Analysis below—that the Central Bank has been overly restrictive in its pursuit of unrealistic monetary targets. To be sure, there is some question as to what extent the Fed's activity was related to the unsettled conditions stemming from the difficulties experienced by a securities firm as opposed to more fundamental considerations. In all likelihood, the former has played a role which suggests that the Fed may pull back somewhat once the market's fears are allayed. Such a pullback, however, should still leave policy in a more accommodative mode than was in effect several weeks ago. Accordingly, most if not all of the interest rate declines recorded over the past week should remain intact over the next month or so. Thereafter, however, the economic and monetary environment is expected to turn decidedly less positive for the fixed-income market.

Special Analysis

The Other Side of the M-1 Base Drift Coin *is coming home to haunt the Fed that finds itself hopelessly boxed into a corner in which it feels compelled to rigorously pursue monetary targets in order to maintain its hard earned and economically costly anti-inflation credibility.* Unfortunately, the Fed's attempt to hit moving targets for aggregates that continue to undergo change as each day passes has tended to perpetuate the very excesses in both directions that the pursuit of monetarism was intended to eliminate. And, *unless a drastic redressing of the entire targeting procedure and aggregate definitions is forthcoming soon, continued failure of the Fed's practice of monetarism seems all but assured—leaving in its tracks further severe strains in the financial system and an aborted economic recovery.*

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Viewing the matter in greater detail, *it is no secret that the Fed's attempt to hit M-1 targets since the mid-1970's has been met with less than resounding success.* In this regard, it would seem reasonable to assume that the most appropriate measure of the Fed's targeting success or lack thereof would be its history of coming close to the midpoint of specified annual ranges established for the fourth quarter of each year. In addition, in those years in which actual growth rates did deviate from target midpoints, a successful approach to targeting would mandate that the miss be consistent with the underlying economic and inflation environment. For example, in years of expanding economic activity and accelerating inflationary pressures, one would assume that the miss should be biased below the midpoint as the Fed seeks to "lean against the wind." In periods of declining economic activity and decelerating inflationary pressures, the Fed would seem justified to aim for a growth rate above the target midpoint.

As the following table clearly shows, however, the only year in which the Fed came close to the midpoint of its targeted range was in 1976 when the fourth-quarter 1975 to fourth-quarter 1976 growth came in just 0.2% above the target midpoint. In each of the following four years when the economy was expanding and inflation accelerating, actual growth exceeded the midpoint of target ranges by anywhere from 1.3% in 1978 to 2.4% in 1977. What is more, in three of those four years the actual growth of M-1 surpassed the upper end of the Fed's targeted range. Ironically, the only year in which M-1 growth fell short of the targeted midpoint was in 1981—a year of recession and a dramatic deceleration in inflation.

Such a performance is most disconcerting in and of itself. Even more disturbing, however, has been the impact of "base drift" on the perpetuation of excesses during periods of over accommodation and stringency during periods of under accommodation. Such a phe-

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nomenon can be seen from columns 3 and 4 in the table. In column 3, for example, is shown what the actual fourth-quarter average M-1 level would have been each year had the Fed achieved target midpoint growth over the actual level that prevailed during the fourth quarter of the previous year. In column 4 is shown the actual M-1 levels that ensued from the year's growth and that were utilized by the Fed as a base of calculation for the subsequent year's targets. In 1977, for example, M-1 would have averaged $325.0 billion in the fourth quarter had the Fed achieved the 5.5% target midpoint growth. However, since M-1 grew at an annual rate of 7.9% in 1977, the actual level stood at $333.3 billion—some $8.3 billion higher than the midpoint of target.

By setting its 1978 target growth rate of M-1 off of the actual prevailing base of $333.3 billion—and not off of what would have been the on-target level—the Fed in essence built in and validated the $8.3 billion 1977 excess through the process of base drift. Most disconcerting was the performance in 1979—a time of rapidly accelerating inflation. After already incorporating the 1977 and 1978 target overshoots of $8.3 billion and $9.8 billion respectively into the new base level for 1979 growth calculation of $360.8 billion, the M-1 increase was some $15.9 billion in excess of the target midpoint. This base excess or drift was also validated in the setting of 1980 targets off of a $387.5 billion fourth-quarter 1979 base level.

In effect, had the actual growth rates over this period been calculated off of the midpoint of the previous year's target—and not the actual higher level—M-1 growth would have been 11.0% in 1978, 10.4% in 1979 and 11.9% in 1980. As a result, the actual M-1 level by the fourth quarter of 1980 stood $42.3 billion higher than the level that would have existed had the Fed hit the midpoint of its targets over the 1976-1980 period. The difference in effect represents accumulated base drift for the period. *Given this consideration, therefore, there is little wonder that inflationary excesses built up dramatically and the recession that was anticipated as early as 1978 was forestalled for two years.*

The other side of the base drift coin, however, is now coming home to roost and is serving to exacerbate the strains in the financial system and recessionary tendencies. In 1981, for example, M-1 growth was 2.3% below the midpoint of the Fed's targets. As a result, the M-1 base level off of which targeted 1982 growth is being calculated is $436.7 billion—$9.5 billion below the base that would have been produced with target midpoint growth. *In essence, not only is the M-1 target for 1982 3.5% lower than that in 1981, but it is being calculated off of a base $9.5 billion lower than it would have been had the Fed hit its 1981 targets.* Along these lines, it should be kept in mind that the Fed set the 1982 targets in July of last year—supposedly on the assumption that the midpoint of 1981 targets would have been achieved.

Given the overly accommodative posture aided and abetted by positive base drift over the 1976-80 period, the Fed was able to sustain negative (inflation-adjusted) short-term rates of anywhere from 1.0% in 1980 to 3.3% in 1979. Certainly, these rates of interest told the true tale of the Fed's posture. *Given the overly restrictive posture in 1981 and thus far this year, on the other hand, real short-term rates were a positive 5.2% last year and stand close to the double-digit area at present—aided and abetted by negative base drift. Certainly, this combined with key sectors of the economy close to depression levels, a sharp deceleration in inflation and minimal reserve growth over the past year or so would appear to tell the true tale of the Fed's posture at present. In light of past and recent developments, it is our view that the Fed should eliminate the practice of base drift and target each year's money supply growth using the target midpoint level in the fourth quarter of each year as the basis of the subsequent year's growth.* In this way, the Fed would find that M-1 growth in early May has been running at an annual rate of 1.8%—below, not above, targets. In future years, such an approach would preclude the Fed's ability of validating and perpetuating either excesses or deficiencies. In effect, if excess growth were to develop one year, it would have to be squeezed out the next and vice versa. Such an approach would buy the Fed breathing room this year while, at the same time, serve as a discipline on the Fed in subsequent years—thus sustaining monetary credibility. Certainly, this approach would be preferable to a raising of the 1982 target ranges.

	Fed. Res. M-1 Target Midpoint	Actual M-1 Growth	Target Midpoint M-1 Level	Actual IV Qtr. Level*	Excess of Actual Over Target
IV Qtr.:					
1975-76	6.0%	6.2%	$307.6	$308.1	$ 0.5
1976-77	5.5	7.9	325.0	333.3	8.3
1977-78	5.3	8.8	351.0	360.8	9.8
1978-79	3.0	5.5	371.6	387.5	15.9
1979-80	5.3	7.3	408.0	415.8	7.8
1980-81	7.3	5.0	446.2	436.7	(9.5)
1981-82	3.8	–	453.3	–	

*Base from which subsequent year's target is calculated.

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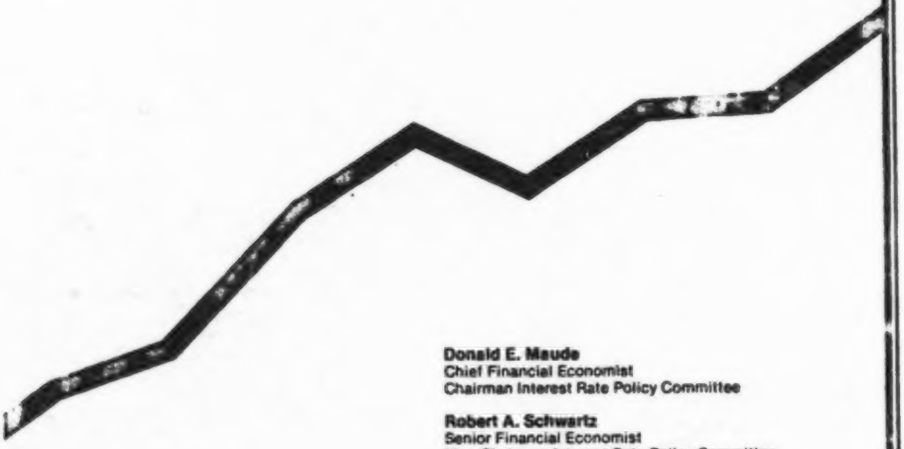
- **The M-2 Targeting Dilemma: Has The Fed Been Chasing Its Own Tail? . . . . .Page 8**



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The M-2 Targeting Dilemma: Has The Fed Been Chasing Its Own Tail?

Since January of this year the pace of economic activity has stagnated, the rate of inflation has receded dramatically from the double-digit to the single-digit territory, bank credit growth has moved comfortably within the Fed's 6%-9% target for the year and shift-adjusted M1-B through July had grown at a rate well below the lower end of the Fed's 3-1/2% to 6% long-term target. Still, with all of this, until just recently the Fed has kept a tight lid on reserve growth and the Fed funds rate was allowed to continue trading in the 18%-20% range during the May-July period—well above the 15% average of February and March.

A major reason for the Fed's posture during the spring and early summer months lies with the fact that M-2 had been growing above the upper limit of its 6-1/2%-9% target range. In the past, with the Fed giving equal weight to both M1-B and M-2 in the formulation of policy, a similar confluence of events would have brought forth a respectable easing in policy and in the Fed funds rate. Over the past several months, however, such has not been the case. The Fed's departure from past practices stems from a decision reached at the March FOMC meeting, when the Committee decided that "greater weight than before be given to the behavior of M-2" in formulating monetary policy.

At that time, it was agreed that a change in emphasis was appropriate in light of the fact that the nationwide introduction of NOW accounts since the beginning of the year had caused a massive shifting of deposits that was expected to continue distorting measured M1-B growth to what the Committee considered an "unpredictable extent." In effect, the Fed was giving recognition to the impact that institutional changes and exceedingly high interest rates were having on transactional balances and decided to focus more on M-2, which measures both transactional and nontransactional (saving-type) balances.

As a result of this decision based upon the staff's analysis, the Fed chose to ignore the fact that real GNP declined by 1.9% and the price deflator receded to an annual rate of 6% during the second quarter and that by June the rate of growth of shift-adjusted M1-B stood 1-1/2% below the lower end of its long-term (fourth-quarter 1981 over fourth-quarter 1980) target. Instead, it maintained a tight rein on reserve growth in response to an 8.8% annual rate of growth in M-2 which stood at the upper end of its long-term target. Still, while the Fed's rationale for initially questioning the reliability of the M1-B data is somewhat understandable, one has to question the inconsistencies between weak economic activity, decelerating inflation, weak bank credit and below target M1-B growth on the one hand and excessive M-2 growth on the other. What is so disconcerting about the Fed's shift in emphasis to M-2 is that it has been done and targets have been established accordingly apparently without the Fed taking cognizance of the dramatic impact that institutional changes, shifting household investment patterns and exceedingly high interest rates have had on nontransactional balances as well.

It is our view that failure of the Fed to do so over the year ahead would preclude any meaningful relief on the interest rate front on a sustainable basis, thereby serving to thwart the Administration's economic recovery program before it has a chance to materialize and guaranteeing that Federal budgetary deficits will mount still further. This would be the case since, according to our calculations (to be elaborated upon later in the Analysis) an 8% plus M-2 growth over the next year would appear extremely likely even with zero growth in its components—M1-B, time and savings deposits, money market funds, overnight RP's and Eurodollar deposits. With these other components growing over the year ahead, of course, excessive M-2 growth would appear all but assured. In such a likely event the question then becomes, can and should a more restrictive monetary policy be successfully employed to reduce the M-2 rate of growth? To gain some insight into the answers to these questions, one must first recognize what impact institutional changes, altered investment preferences of consumers and practices of financial institutions, monetary aggregate definitional considerations and a high interest rate environment have had on M-2—as contrasted to actual Federal Reserve policy actions.

The Changing Nature of M-2 Since the Mid-1970's...

Several dramatic and critical institutional developments in the financial system and markets have emerged since the mid-1970's. These developments, in turn, have had a profound impact on M-2 growth over the past several years. In the past, it should be kept in mind, M-2 merely consisted of currency, demand deposits and time and savings accounts of commercial banks. The yield on the latter accounts was governed by Regulation Q. During past periods, the monetary mechanism worked quite well, though it was not without its temporary painful effects on the banking system and the housing market and inequities to small savers who were generally precluded from the opportunity of earning competitive market rates of interest on money market instruments—whose denominations were too large for all but the most wealthy individuals and large institutional investors. During periods of monetary tightness, yields on credit market instruments (Treasury bills, Federal Agency securities, etc.) tended to rise above those available on time and savings accounts—causing disintermediation from M-2 type deposits into the credit markets. This changing flow of funds, of course, resulted in a weakening in M-1 and M-2 growth and subsequently led the way for an easing in monetary policy and interest rates.

In the 1970's, however, the financial system began developing ways to adapt to the monetary impact on flows. The first response in the early 1970's was the creation of the money market mutual fund as a vehicle by which small savers could take advantage of competitive money market yields. It was not until the late 1970's ushered in sustained historically high interest rates, however,

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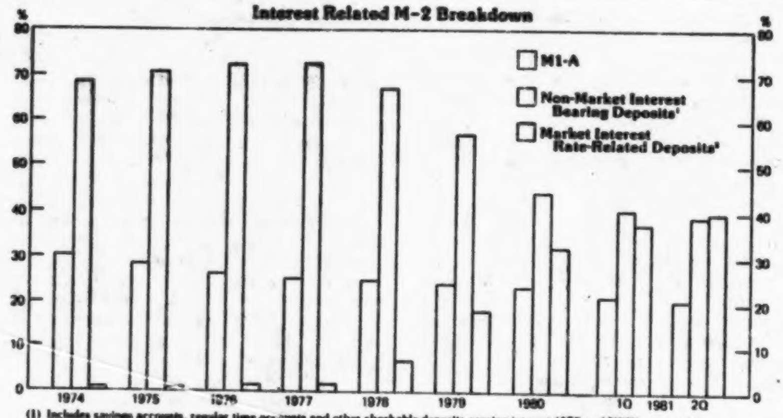

Interest Related M-2 Breakdown

(1) Includes savings accounts, regular time accounts and other checkable deposits earning interest (ATS and NOW accounts).
(2) Includes special 6-month money market CD's, 30-month savings certificates, money market fund shares and overnight RD's and eurodollar deposits.

that they began to grow rapidly. The second response came from financial institutions during the summer of 1978, when it was felt that 7%-8% money market rates would lead to massive disintermediation and a collapse in the housing market. At that time, the Federal Reserve and the Federal Home Loan Board decided to allow commercial banks and nonbank thrifts to issue special 6-month money market certificates and 30-month savings certificates at market rates of interest (tied to the comparable maturity Treasury yield) and in denominations small enough to attract funds from smaller savers and investors. The most recent response by institutions who are precluded from liquidating securities because of the substantial realized losses that would be incurred has been the increased utilization of such portfolios to gain funds through RP's.

In recognition of the fact that a growing proportion of what the Fed considered alternatives to traditional savings account type vehicles that were not being captured by the old definitions of M-2, this aggregate was redefined in 1979 to include deposits of nonbank thrifts, money market funds, RP's and Eurodollar deposits. Apparently not recognized by the Fed at the time would be the role played by the shifting composition of savings and investments and interest rates themselves in M-2 growth.

Looking at this matter in more specific terms, the rapidly growing role that interest rates themselves have played in M-2 growth is illustrated in the following bar chart. As it shows, the noninterest bearing component of M-2—which is the same as M1-A—in 1974, the year of the previous cyclical peak in interest rates and monetary retraint, represented 30% of the total. Basically all of the remainder of M-2 was represented by time and savings accounts that earned a low nonmarket rate of return of about 5%. By 1977, the noninterest bearing component had declined to 25% of the total and time and savings deposits rose to about 73% further increasing the proportion of M-2 earning interest. However, only 2% of the total actually earned a higher market rate of interest and that was only slightly more than 5%. Since mid-1978, however, money market rates have risen to levels almost three times higher than rates than can be earned on savings and short-maturity time deposits and the growth of special money market certificates and money market funds have literally exploded. As a result, during the second quarter of this year, M1-A represented only 21% of the total, nonmarket interest earning deposits 39% and higher yielding market rates of interest components a full 40% of the total. These higher yielding components are up sharply from 19% in 1979 and 32% in 1980. The rapidly rising proportion of M-2 earning market rates of interest since 1977 has additionally been augmented by an actual doubling in the level of money market rates.

The combination of these two factors is reflected in Table I, which shows a breakdown of the components of nontransactional M-2 (M-2 minus M1-B). In the upper part of the table is the actual average dollar level for each component since 1975 and the estimated interest rate of return paid. The bottom of the table shows the actual dollar amount of interest that accrued to each component during the same period. For savings accounts, for example, we have assumed an interest rate of 5.2% per year. Prior to 1979, commercial banks were allowed to pay 5% and nonbank thrifts 5-1/4% on such deposits. After 1979, however, the ceiling was raised to 5-1/4% and 5-1/2% respectively. Generally, these deposits have been about equally distributed between the banks and the thrifts. For time deposits, the calculations were somewhat more complex since they include regular relatively low yielding time accounts and higher yielding, special 6-month money market CD's and 30-month savings certifi-

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Table I

Nontransactional M-2 Components And Interest Paid

	Nontrans. M-2 (M2-M1-B)		Savings Dep.		Small Time Dep.		Money Market Fund Shares N.S.A.		Overnight RP's & Eurodollar Dep. N.S.A.	
	Level	Interest Rate	Level	Interest Rate	Level	Interest Rate	Level	Interest Rate	Level	Interest Rate
I. Average Levels & Prevailing Rate of Interest										
1975	$ 735.4	5.8%	$383.9	5.2%	$340.4	6.6%	$ 3.6	5.5%	$ 7.5	5.3%
1976	861.3	5.8	447.7	5.2	396.6	6.6	3.4	5.8	13.6	5.1
1977	963.8	5.8	486.5	5.2	464.9	6.6	3.8	5.3	18.6	4.3
1978	1044.1	6.1	476.1	5.2	533.8	6.7	10.3	7.8	23.9	8.0
1979	1142.1	7.0	416.7	5.2	656.5	7.6	43.6	11.0	25.3	11.1
1980	1235.6	7.9	396.8	5.2	709.9	9.1	69.8	12.6	28.1	13.4
1981										
IQ	1280.3	9.9	372.0	5.2	782.8	11.1	92.9	15.5	32.6	17.2
IIQ	1316.0	10.4	360.7	5.2	798.9	11.5	119.3	16.2	37.1	18.3
II. Actual Interest Paid										
1975		$ 42.8		$19.7		$22.5		$ 0.2		$0.4
1976		50.0		22.9		26.2		0.2		0.7
1977		55.9		24.9		30.0		0.2		0.8
1978		63.2		24.4		36.1		0.8		1.9
1979		79.5		21.9		50.0		4.8		2.8
1980		98.0		20.8		64.6		8.8		3.8
1981										
IQ*		126.3		19.6		86.7		14.4		5.6
IIQ*		137.6		18.8		92.8		19.2		6.8

* Annual Rates.

cates—the composition of which has undergone major shifts through the years.

By way of example, up until mid-1978, all time deposits were of the lower yielding nature. The allowable yield schedule on such deposits varied from 5% to 7-3/4% up until the late-1970's and from 5-1/4% to 7-3/4% thereafter, depending upon maturity and the depositoty institution. For simplicity, we have conservatively estimated an interest rate of 6.6% on these accounts. By the second quarter of this year, however, the composition of time deposits was dramatically different. The lower yielding regular time accounts had declined to 32% of the total, 30-month certificates moved to 10% and special money market CD's soared to 58% of the total. To take these shifts into account, we calculated the return on money market CD's by using the average 6-month Treasury bill rate for the periods and on 30-month certificates by using the two-year average yield on comparable maturity Treasury notes—off of which their returns are pegged. Weighting the total time deposit component accordingly, we find that the rate of return rose from 6.7% in 1977 to 11.5% during the second quarter of this year. For the yield on money market funds, we have used the 90-day commercial paper rate as a proxy and for overnight RP's and Eurodollar deposits we used the average Fed funds rate.

These interest earnings estimates, we would point out, are on the conservative side since money market fund yields have at times exceeded those on commercial paper, Eurodollar deposits generally yield more than the Fed funds rate and the other checkables in M1-B were not imputed with any interest return—when in fact they do earn over 5% in general. On the other hand, we do acknowledge the possibility that actual interest income estimated on 6-month money market CD's and 30-month certificates may be overstated somewhat for a given period when rates were higher than the preceding period since some of these instruments are those that were issued during the prior period at the then existing yields. The combination of these considerations, however, would suggest that the overall returns indicated are sufficiently representative.

As the table shows, the interest rate factor in M-2 since 1977 has increased dramatically. In 1977, interest paid amounted to $55.9 billion—or $4.7 billion per month. During the second quarter of this year, interest paid ran at an annual rate of $137.6 billion—or $11.5 billion per month. Table II provides still another way of looking at the matter by showing the actual dollar changes in M-2 and interest paid and the percentage of the total change represented by interest alone. Back in 1975, for example, 36.8% of the increase in M-2 was accounted for by interest. In 1980, interest paid represented 96.9% of the increase in M-2. These statistics point to the dilemma now faced by the Fed. Given annualized interest payments on M-2 components in June running at an annual rae of $138.6 billion and should no sustained decline in interest rates occur over the next year, the interest component alone will provide an 8% rate of growth in M-2 over the period. Yet, if the Fed dogmatically pursues an

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M-2 growth target of 6-1/2%-9% and other components grow as well (even if M1-B growth remains at the lower end of the Fed's 1982 targets) M-2 growth on balance will be at the upper end or above its target. If this turns out to be the case, however, there would be little reason to expect any easing in policy or decline in interest rates. What's even more disconcerting is the fact that the trend growth of market related components of M-2 has accelerated recently. This would imply even higher interest rate component growth as each month goes on. In effect, the Fed will find itself likened to the dog that continues to chase its own tail. The faster it chases, the faster the elusive tail moves. The same could be the case with M-2 targeting without taking into account the interest rate factor.

Despite the dramatic bloating effect interest has recently had on M-2 growth, one might make the case that the source of M-2 growth is really a moot point. The important consideration is deposits have in fact grown at an overly rapid rate. However, in this regard, one must define the relevance of M-2 and determine if the current aggregate does in fact measure what it is supposed to gauge. Along these lines, it has been pointed out in Federal Reserve literature that the purpose of the M-2 measure is twofold: first, to measure the availability of new lendable funds in financial institutions and, second, to measure overall liquidity—or spending potential—in the economy.

Gross M-2 As A Proxy Of The Availability Of New Lendable Funds

One of the major concerns on the part of the monetary authorities with rapid M-2 growth over the second half of last year and thus far this year is that it suggests that the banking system—both commercial banks and nonbank thrifts—are flush with newly created funds that can be unleashed at any moment to fuel an inflationary pace of economic activity. Yet, this perception about all financial-type institutions just does not mesh with the well-known plight of nonbank thrifts and the relatively modest increase in total commercial bank credit since the beginning of the year.

Table II

Relationship Between M-2 Changes And The Interest Rate Component

($ Billions At Annual Rates)

Period	M-2 Level	M-2 Increase	Interest Paid	% of M-2 Gains Represented By Interest
1975	$1022.4	$116.2	$ 42.8	36.8%
1976	1166.7	144.3	50.0	34.7
1977	1294.1	127.4	55.9	43.9
1978	1401.5	107.4	63.2	58.8
1979	1525.5	124.0	79.5	64.1
1980	1603.9	105.4	98.0	93.0
1981				
IQ	1698.3	137.2	126.3	92.1
IIQ	1743.3	180.1	137.6	76.4

Again, the problem of using M-2 as a proxy rests with the fact that it measures changes in "gross" deposits not net new deposits after required interest payments are deducted. This is quite ironic when one considers the fact that the outflow of funds from the savings and loan associations has been a highly publicized phenomenon. For example, many in the financial community are aware that the S&L withdrawals exceeded new deposits by $4.6 billion in April, a minor bit in May and a whopping $5.6 billion in June. Yet, they are not aware that after taking into account interest credited to accounts, the outflow in April was only $2.9 billion and gross deposits and interest actually increased by $1.7 billion in May and close to $500 million in June. The reason increases in deposit levels due to interest crediting is not deemed important in the thrift industry is due to the fact that it does not represent net new external sources of deposits with which mortgage lending can be expanded. In effect, increases in deposit levels due to interest crediting merely represent a shifting of funds from one area of the institution to the other—usually from operating revenues or capital. If a net deposit outflow is just matched by interest credited, the institution has not gained any net new external funds.

The same case applies to the commercial banking system components of M-2. Net new lendable funds that banks previously did not have only materialize when the gross deposit increase exceeds the amount of interest that has to be transferred from one area of the bank to the actual accounts. Table III, which shows the financial institution M-2 sources of funds—M-2 less money market fund shares—indicates that throughout the last half of the 1970's gross deposit increases did exceed interest paid; resulting in net deposit gains. However, two key developments have tended to mute such gains and to lead to actual net losses in 1980 and the first half of 1981. First, gross annual gains in time and savings deposits declined from a high of $120 billion in 1976 to $33.5 billion in 1980 and $19.2 billion during the second quarter of this year. At the same time, interest paid on such accounts moved from $49.1 billion in 1976 to $85.4 billion in 1980 and $111.6 billion during the second quarter of 1981. As a result, what were net gains of $70.9 billion in time and savings deposits in 1976 became net outflows of $51.9 billion in 1980 and a $92.4 billion annual rate during the second quarter of this year. As the table shows, these outflows were further augmented by net outflows from overnight RP's and Eurodollar deposits in 1980 and the first quarter of this year and were stemmed somewhat by an increase during the second quarter. In 1980, these outflows were negated to a certain extent by an increase in demand deposits and currency and other checkable deposits. However, on a net after interest basis, at depository institutions, M-2 declined by $40.5 billion in 1980, $22.4 billion during the first quarter of this year and at an annual rate of $44.0 billion during the second quarter.

This net outflow of deposits, of course, forced the financial institutions to scramble for funds from more broadly defined M-3 sources—such as large time deposits, term RP's and Eurodollars and CD purchases by

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Table III

Net Changes In Bank Related M-2 and M-3

($ Billions At Annual Rates)

M-2

	M1-B		Non-MMF M-2		
Period	Net Change In M1-A	Change In Oth. Check.	Net Change In S&T Dep.	Net Change In P.M. RP's & Euros.	Net Change In Total Non-MMF M-2
1974	$11.2	$ 0.1	$- 2.3	—	$ 9.0
1975	12.6	0.7	59.3	-0.1	72.5
1976	17.1	1.6	70.9	5.4	95.0
1977	23.4	1.4	42.2	4.2	71.2
1978	23.2	4.2	8.0	3.4	38.8
1979	18.1	8.4	- 8.6	- 1.4	15.5
1980	10.1	6.4	-51.9	- 5.1	-40.5
1981					
IQ	-81.2	119.2	-54.8	- 5.6	-22.4
IIQ	-19.6	56.8	-92.4	11.2	-44.0

M-3

Period	Net Change Term RP's & Euros.	Net Change In MMF CD Holdings	Net Change In Large Time Dep.	Total M-3 Comp.	Total Net Change
1974	—	—	—	—	—
1975	0.9	—	-19.4	-18.5	54.0
1976	7.1	—	-17.8	-10.7	84.3
1977	7.9	—	19.0	26.9	98.1
1978	11.4	5.7	33.5	50.6	89.4
1979	5.4	28.4	0.1	33.9	49.4
1980	6.8	17.1	-15.5	8.4	-32.1
1981					
IQ	-4.5	0.6	54.4	50.5	28.1
IIQ	-6.5	1.9	-22.4	-22.1	-66.1

money market funds, as is indicated in the lower half of the table. Still, even with these other sources, the institutions experienced a net outflow of $32.1 billion in 1980, a net gain of $28.1 billion in the first quarter and an outflow of $66.1 billion during the second quarter. In effect, the bloating effect of the interest rate factor since 1979 has masked the fact that a respectable amount of actual disintermediation has been underway—and has dramatically accelerated over the past several years.

M-2 As A Proxy of Overall Liquidity In The Economy

Table IV shows shifting financial asset preferences of the household sector since the mid-1970's. During the last period of cyclically high interest rates in 1973 and 1974, for example, over one-third of the acquisition of liquid financial assets were in the form of credit market instruments—primarily in U.S. Government securities. As rates came down in 1976, on the other hand, funds flowed back into the banking system and credit market instrument holdings declined to about 15% of all such assets. In 1979, as rates once again began to rise sharply, the proportion of these holdings moved back above 38% of the total. Since that time, however, the pattern has changed dramatically. In 1980, for example, despite lofty interest rates throughout the major part of the year, the proportion of liquid financial asset acquisitions represented by credit market instruments declined to 15.5%. During the first quarter of this year, the household sector actually liquidated credit market instruments at an annual rate of $23.5 billion.

This does not imply that the individual's interest in market-related high yielding investments has diminished, however. Instead, with convenience that money market funds afford and the fact that their purchase does not encompass the payment of a commission (or load), they have taken the place of former investments in credit market instruments. During the first quarter of this year, for example, almost 75% of the increase in liquid financial asset holdings were in the form of money market fund shares. Unlike credit market instruments, however, money market funds represent part of M-2. Indeed, fully 63% of the M-2 increase since last December has been accounted for by money market funds. To the extent that money market fund share holdings represent an alternative to other investments, however, one could seriously question their inclusion in a monetary aggregate intended to measure savings-type deposits that have the potential of being converted into transactional balances at any time. Given the fact that the number of times checks are actually drawn on these funds over the course of a year is minimal, it is difficult to differentiate them from other credit market instruments that are not included in M-2.

Due to such shifting investment preferences between credit market instruments and alternatives classified technically as deposits and the growth of the economy over the years, a more accurate measure of liquidity should take these developments into consideration. In the following table, for example, is shown the total of all deposits (which would include money market funds) and credit market instruments as a percent of both disposable personal income and current dollar GNP. As it shows, both measures of liquidity reached a high in the 1977-79 period and has since declined. Indeed, deposits and credit market instruments as a percent of GNP was lower during the first quarter of this year than was the case during the highly illiquid 1974 crunch period. The lack of an overabundance of liquidity in the economy has been further mirrored in the rate of growth of M-2 plus other liquid assets thus far this year. Specifically, after growing at an average annual rate of 10.5% during the 1977-79 period, this measure of liquidity slowed to 9.1% in 1980 to an annual rate of 9.5% in the first quarter of this year and to less than 7% in April and May. This stands in sharp contrast to the acceleration in M-2 growth over the comparable periods.

Conclusion

A substantial portion of rapid M-2 growth throughout the major portion of 1980 and thus far this year seems to be more reflective of recent institutional changes in the fi-

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Table IV

Breakdown Of Liquid Financial Asset Holdings Of The Household Sector

($ Billions At S.A. Annual Rates)

Period	Deposits & Credit Mkt. Instruments	Credit Mkt. Instrument	Credit Mkt. Instruments As a % of Total	Money Mkt. Funds	Money Mkt. Funds As a % of Total	Other Deposits	Other Deposits As a % of Total
1973	$116.3	$38.6	33.2%	$ —	0%	97.7	84.0
1974	104.4	38.8	37.2	2.4	2.3	63.2	60.5
1975	119.9	30.6	25.5	1.3	1.1	88.0	73.3
1976	146.9	22.7	15.5	—	0	124.2	84.5
1977	168.5	36.5	21.7	0.2	0	131.8	78.2
1978	188.4	58.1	30.8	6.9	3.7	123.4	65.5
1979	211.1	81.5	38.6	34.4	16.3	95.2	45.1
1980	197.0	30.6	15.5	29.2	14.8	137.2	69.6
1981							
IQ	199.1	(23.5)	(11.8)	148.4	74.5	74.2	37.3

nancial system, shifting household investment preferences, definitional considerations with regard to the aggregates and historically high interest rates. It has not, in our view, served as an accurate or reliable proxy of the availability of new lendable funds in the financial institutions or overall liquidity in the economy. As such, continued emphasis on this aggregate as a determinant of monetary policy over the quarters ahead would only insure its continued rapid growth and lofty interest rate levels and a sustained period of economic stagnation. Such a policy would seem to us to be ill-advised.

Indeed, blind pursuit of such established targets that were set long before the Fed had any inkling of recent developments would appear entirely fruitless. This is the case since the most rapidly growing components of M-2 recently are those completely outside of the Fed's direct control and their growth is being fostered—not curtailed—by high interest rates and a restrictive monetary policy. Along these lines, it is a widely accepted fact of life in central banking circles that the broader the aggregate, the less direct control over it is capable of being exerted. It is because of this that the Fed has pursued a policy of controlling reserves under its operating procedures established in October 1979. Measured in these terms, the Fed has been tight since the end of last year indeed. Since that time, total reserves have grown at a meager 1.1% annual rate and nonborrowed reserves have actually declined at an annual rate of 0.7%.

Given this consideration, one would certainly question the reliability of "gross" M-2 growth over the same period as a proxy of the stance and as a guide to the conduct of monetary policy. These measures combined with sluggish M1-B growth over the first half of 1981 seem more consistent with the recent weakness in interest-rate adjusted—not gross—M-2 growth. Perhaps the Fed should take these two measures into account in establishing targets and gauging the impact of its policies. This would dictate a lower interest-adjusted and a higher gross M-2 target range that is currently being pursued.

When all is said and done, therefore, the conduct of monetary policy on the basis of the performance of a single measure of money supply—whether it be M1-B or M-2—carries with it substantial risks. These risks have not been fully appreciated by those in the monetarist camp who have claimed through the years that the simple way to achieve sustained economic growth and reasonable price stability is through the establishment of an appropriate steady path of "money supply" growth.

As a result, there is no getting away from the fact that monetary policy is more an art than a science. As such, any one monetary measure must be complemented by other measures of money, reserves, the overall level of interest rates, the state of the economy and inflation and inflationary expectations in the formulation of monetary policy. It is upon all of these factors—not just a single criterion—that the success of lack thereof of the Fed's policy stance should be gauged. Using this broader criterion, the Fed has been anything but expansionary since November 1980 as has been suggested by rapid gross M-2 growth. As a result, Fed policy has been significantly more credible than skeptics apparently perceive.

Table V

Relative Measures Of Liquid Financial Assets

($ Billions At S.A. Annual Rates)

Period	Liq. Fin. Assets As % of DPI	Liq. Fin. Assets As % of GNP
1973	8.5%	8.8
1974	6.6	7.3
1975	8.1	7.7
1976	10.4	8.6
1977	12.8	8.8
1978	12.9	8.7
1979	12.9	8.7
1980	10.8	7.5
1981		
IQ	10.3	7.0

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Mr. Maude. I need not elaborate here on the dismal economic performance that has transpired since 1979. A lot of those were alluded to this morning in terms of the state of illiquidity—and I am departing from the text—in terms of the state of illiquidity in the corporate sector, the fact that fully 85 percent of all S. & L.'s now who open their doors are losing money each day because of the negative spread of 1½ percent. The farm sector—we all know how serious the situation is there. We know that we've been in a recession, or practically in a recession, for almost 3 years, which is unprecedented in post-war history. Production is lower now than it was 3 years ago. The gross national product, even with the increase that we got for the second quarter, which is illusory, I would suggest—we are looking at an economy which is really, really in dire straits.

If you look at the corporate sector, the balance sheets are more liquid than they have been since the Depression. We already know that bankruptcies are at depression levels.

SERIOUS CONTRADICTIONS

With the confluence of these situations and the fact that inflationary psychology has been snapped in the bud, at least temporarily, in the commodities markets, in terms of labor negotiations—it seems to me, as recently as last year, that there were some very serious contradictions going on.

This became even more clear to me during the first half of the year.

We're looking at a situation where we were in the eighth postwar recession. We're looking at a situation where inflation had been decelerating very dramatically. We're looking at a situation where we were getting depression levels in housing and autos and all this illiquidity, and yet, all along, for the first 5 months of the year, we had all these situations at the very time that the Fed was having to maintain a restrictive policy because the stated rate of growth of M_1 and the stated rate of growth of M_2 was running above targets.

Something had to be inconsistent there. You don't have money supply in terms of what it's supposed to measure and what it has measured in the past, going above targets during a period when you've got these economic events going on. And it led me to do a little bit of work.

In terms of M_1, for example, and there's a lot of importance on M_1 and M_2—I heard it mentioned more here today than I have a lot of other hearings, but it's important in terms of the rational expectations in the credit markets. When the Fed sets a target for an aggregate and it fails to hit that target, it does risk the chance of losing its credibility.

I was very disturbed to a certain degree to hear Chairman Volcker indicate that he was willing to tolerate M_1 growth above target. I am agreed that they have to be accommodative. But I think that there are technical things that Chairman Volcker can do and the Fed staff can do to take away that risk of credibility loss and still allow them to be more accommodative.

My studies in M_1, for example, have shown that M_1 has really, if you make the proper adjustments and you try to measure transaction balances, which is what M_1 historically has measured, if you make the appropriate adjustments out of the stated M_1, you probably will have found out that all through the first half of the year, M_1 has been growing at the lower end of its targets.

Now I make that conclusion on the basis of two criteria. You know last year, the Fed, because of the nationwide introduction of NOW accounts, the Fed initially allowed for an adjustment to M_1 by shift adjusting that proportion of NOW accounts or other checkable deposits that they presumed through survey came from savings accounts, in order to net out savings money from M_1.

They did that all last year. During the spring and the summer, this big surge in the demand for people to shift money into NOW accounts started to wane. Other checkable deposits started increasing by a modest amount every month during the summer.

So at the end of the year, the Fed assumed that that had transpired and they went into an M_1 definition without distinguishing any more how much of that M_1 was coming from other checkable deposits.

I don't know why they did that, because starting in October, there was a renewed surge in other checkable deposits. I've got a table indicating that in my statement. And what you'll find out is that if you take the M_1 increase from October, which is when we had the major acceleration, you'll find out that 86 percent of that increase was in the form of other checkable deposits, or what Chairman Volcker refers to as NOW accounts.

Now in my mind, given the fact that the economy had hit the low point or actually, was declining rapidly, consumer confidence underwent a sharp contraction in November and December. In my mind, a lot of this buildup in M_1 was due to the fact that people were scared. They were not letting their money roll over in 6-month money market CD's.

I can assure you—I have done the work on it—the data flows in terms of what happened to savings deposits and money market CD's shows that there was a major move out of anything with a fixed rate obligation or a fixed maturity obligation because people were getting scared.

So I think a lot of the M_1 buildup in November and December, and I think it can be justified on a careful analysis of reserve and savings and demand deposit flows, and I think that that has done this internally.

They couldn't make the proper adjustment and I guarantee you, M_1 was not growing above targets, M_1 that we used to know as a transaction balance measure.

I am kind of perplexed that the Fed has not deemed it worthy to go back to making these appropriate adjustments and announcing it to the market. So I think that that makes a lot more sense than merely indicating that we're willing to let money grow above targets. Explain why you are, come out with adjusted numbers that the markets can look at.

M_2 GROWING ABOVE TARGETS

The other anomaly that I found out, especially during the spring of last year, as we were starting to slip into the recession, was that the Fed was adhering to a very tight policy during the spring and summer of last year. M_1 was growing way below targets. Why were they adhering to a policy? Because M_2 was growing way above targets.

That led me to look at something else which I found very perplexing. If you take into account the fact that we've had major institutional changes over the second half of the 1970's and the fact that back in 1974, 1 percent of M_2 was earning a market-related rate of interest. As of last year, 47 percent of M_2 was earning interest.

Now this interest being credited to the accounts and being rolled over is not net new money being created by the monetary policy; it's merely money being shifted from a bank's capital or a bank's profits into an account.

I think the perfect example there is if you look at the S. & L. flows—the savings and loans. Interest being credited there is being taken now directly from capital. That's why you're seeing capital erode every month that the numbers come out and it's going to consumers. But that doesn't mean that this is net new money being created by the Fed. But it is picked up by M_2.

And if you were to look more realistically, if you were to equate M_2 and all the monetarist studies, look at relationships based upon M_1 of the last 50 years and even more, and M_2 of the last 50 years and even more, my argument is equate what we're looking at now with what it was 10 years ago and 15 years ago.

What I did do was to go back and look at M_2 in 1974, which had no money market funds in it—it had small savings deposits—net out the interest that was being paid, and come out with an interest-adjusted M_2.

Now I carry that through to the later years and obviously, the interest-adjusted part gets larger. If you look at column 3, in 1974–75, the interest credited to M_2, time and savings accounts, is $42.8 billion. In 1981, it was $135 billion. In the second quarter of this year, it was $155 billion. This is just interest being credited.

So what I did was to take the stated M_2 and net out the interest and what we find is a completely different pattern of M_2 growth. Instead of growing 8.5 percent in 1979, 8.3 in 1980, 9.8 last year, and around 9.6 the first half of this year, if you adjust for interest, you will find out that the pattern of M_2 follows the pattern of the economy over the past 3 years. It went from 4.3 in 1978, down to 3.2 in 1979, 2 percent in 1980, 1.7 percent last year, and roughly 1.7 percent the first half of this year.

I think if you look at the adjusted numbers, they tend to track much more closely with what we've been seeing in reality. And I think that these numbers have not been measuring what they're supposed to measure.

I'm not refuting the relationships of what we used to know as M_2 with the economy in inflation and what we used to know as M_1. What I'm merely suggesting is that appropriate changes have to be made.

Let me just list a couple of proposals that I would make to the Fed if I were capable of doing so.

First of all, I would refine those definitions of M_1 and M_2. Second, I would continue, as Chairman Volcker has been doing, to follow a policy geared toward looking at a number of aggregates and a number of variables, not just slavishly adhering to an M_1 or an M_2 target. I think that bank credit should be looked at much more closely than it is right now.

ELIMINATE "BASE DRIFT"

Another thing that I think is very important, and I don't want to get technical, but this has been going on for a couple of years underneath people's noses without realizing it—I think the Fed should be forced to eliminate the use of what we call the "base drift." Now base drift worked to the Fed's advantage through the 1976–79 period. Merely what that means is the fact that if the Fed overshoots their target in any one year, when they set their targets for the year after, they use that higher fourth quarter base to calculate the growth rates.

So what they're doing is validating excessive growth in periods of inflation when they overshoot the targets.

Likewise, if you look at the other side of the coin, last year the Fed missed their targets. They came in below their targets. So what that did was to cause the Fed to have to go through negative base drift, which in effect meant it had to be substantially more restrictive than it would have had to be.

So I think that an appropriate policy would be to have the Fed go back each year they have to set—they have to use as a base to calculate the growth rates for the subsequent year the midpoint of the target for the current year. That will allow base drift either in a positive way or in a negative way.

I think another thing that I would recommend, and I don't want to join in with the administration on this, I would recommend that they try to smooth out their operating procedures. I think if you look at the chart on page 11 of my presentation and look at the rollercoaster course in nonborrowed reserves, which is the broken line, and the rollercoaster course in M_1, you'll find out that had they tried to smooth out their nonborrowed reserve provision, which is what they target, you could have had a much smoother course of money supply.

I think next to finally the Fed ought to immediately institute their practice of publishing 4-week moving averages of M_1. I don't know why they haven't come through with that. With all the gyrations in money that we saw in June and July, that was an appropriate time to do it. My studies have shown me that they would reduce the volatility on an average by more than 1 billion if they would do something like that. It's not that difficult a thing to do. Why are they dragging their feet?

Finally, another recommendation which I think is worthy of consideration—I know the monetarists will kill me for this—but I think it might be an interesting exercise to see what would happen if the discount rate were geared toward some rate of inflation. For example, the 12-month moving average of the personal consumption expenditures, maybe 2 or 3 percent above it. It would not put a control on the Fed funds rate, but at least on the discount rate it would be sensitive to inflation.

If that were intact in 1980, I doubt that we would have needed credit controls because the discount rate would have gone up to 20 percent. And that's the floor on the Fed funds rate. The funds rate would have gone even higher. I think you would have had the recession, or at least a slowdown, long before we had to put on credit controls.

I think, by the same token, if it followed inflation, if it followed the deceleration we've seen over the past year, I don't think you would have seen the economy as weak as it is now, either, because it is a floor.

I don't say control the Fed funds rate. Let that still operate according to the supply and demand for reserves. But the discount rate does have an influence. And to the extent that that could have brought it down, that may have helped. And to the extent if the Fed does enter into a new inflationary posture, they have no choice. The discount rate has to go. It would be changed every month with the release of the personal consumption expenditure.

With that, Mr. Chairman, I'll conclude.

The CHAIRMAN. Before we turn to Mr. Olsen, let me just say on your last three comments, on the nonborrowed reserves, the weekly reporting and the floating discount rate, I badgered the Fed about that for at least the last 3 or 4 years. They've never come here to a hearing that I didn't ask them why they didn't do those things.

So I can't answer why they have not. But on those three points, I certainly agree with you. The mechanics of handling that would be much better if they would change their procedures.

Mr. Olsen?

STATEMENT OF LEIF H. OLSEN, CHAIRMAN, ECONOMIC POLICY COMMITTEE, CITIBANK, N.A.

Mr. OLSEN. Thank you, Mr. Chairman. I welcome this opportunity to share with you some of my views on monetary policy and the economy.

I have submitted a very brief statement that is well within the confines of the 10-minute limit on witness' remarks and I would like to go through it rather quickly.

The CHAIRMAN. Our problem is not controlling witnesses; it's ourselves that are hard to control. [Laughter.]

[The complete statement follows:]

Statement by

Leif H. Olsen
Chairman Economic Policy Committee
Citibank, N.A.

Mr. Chairman, I welcome this opportunity to share some of my views on monetary policy and the economy.

There is today a very considerable concern about the high level of interest rates. There are many people who believe these interest rates are high because the Federal Reserve is pursuing an overly restrictive monetary policy. This reasoning leads to the conclusion that interest rates could be reduced rather quickly if only the Federal Reserve would adopt a more expansionary monetary policy. In my opinion, Mr. Chairman, this proposition is invalid and it could lead to serious mistakes if it becomes the rationale for a change in Federal Reserve policy.

The primary objective of monetary policy is not interest rates, but income. Changes in the rate at which the money supply grows, together with its velocity or turnover, determine increases in the money value of all output of goods and services in the United States. Or to put it another way, the growth of the money supply determines the rate of increase in dollar income.

Over the past four years, the monetary authorities have sought to slow the average growth of money income in an effort to reduce the rate of inflation. In this regard, the monetary authorities should be credited with success in reducing inflation from 9-10% in 1981 to an estimated 6-7% in the current calendar year. Inasmuch as the Administration has explicitly supported this objective of monetary policy, it, too, should be commended for the cooling of inflation.

Inflation in 1976 averaged only 5.2%. By 1981 inflation, as measured by the GNP deflator had risen to more than 9%. But this year inflation is expected to average only 6-7%. Achieving this reduction in inflation has not been pleasant.

Real output has not increased since the first quarter of 1979. The year-long recession that began in July 1981 partially explains this stagnation in physical volume of production. But monetary policy, on average, has achieved a slowdown in nominal income in these past three years and because of the imprecision in the execution of monetary policy, it also produced the recession that we are now suffering. Clearly disinflation is not painless. But I would quickly point out that returning to inflationary monetary policies is hardly a painless alternative. And there are some measures which could to help to mitigate the distress of the from high and accelerating inflation to decelerating and lower inflation.

Ambiguity regarding both the near-term and the long-term course of economic policies sharpens the pain of disinflation. For example, there are employed people who are so thoroughly convinced that efforts to combat inflation will fail that they are seeking very large wage increases to protect themselves. The political cost of ending inflation, they reason, is too high. Their large wage demands, if met by employers, can only be sustained in these times of weak demand by trimming the total wage bills through layoffs. The lucky ones who retain their jobs have higher wages but at the expense of increased unemployment.

Businessmen are also plagued by uncertainty when they look at the abortive antiinflationary efforts that litter the political landscape of the past 15 years. Why, they ask, should this episode be any different. It is only a matter of time before monetary policy will have to yield to the political pressures for the reacceleration of money growth. And the financial markets continue to behave as if they expect that inflation will accelerate once again in the years ahead. The unwillingness to buy long-term bonds is a manifestation, not only of the losses that have been inflicted on investors by accelerating inflation over the past 15 years but the fear that this history will be repeated.

Are these fears and uncertainties justified? Look at the debate over fiscal policy alone. The refusal to reduce government spending sufficiently to achieve a meaningful reduction in the federal deficit is used to support the belief that inflation will accelerate again. I recognize that substantially higher taxes could also reduce the deficit but such an increase in taxes is not as beneficial as cutting spending. Higher taxes finance higher levels of federal spending, and higher spending is associated with higher inflation. In the heat of political debate partisans quite naturally seek to intimidate opponents whom they believe to be responsible for the distress and the pain caused by efforts to reduce inflation. But members of Congress should be mindful that such debates only serve to convince the people that inflation will soon accelerate. Congressmen are often quoted word for word by members of investment policy committees who are arguing against purchases of long-term, fixed-rate government and corporate bonds. People in the financial markets are not unmindful that government is issuing long-term, fixed-rate bonds to finance current consumption of those Americans who are beneficiaries of the various federal transfer programs. The failure to acknowledge explicitly that it is the intent of policy to reduce inflation permanently is feeding cynicism. And that cynicism is heightened by partisans who are intent on raising the political costs of fighting inflation.

A Congressional resolution providing explicit bipartisan agreement that monetary and fiscal policies are engaged in a long-term effort to reduce inflation and that this policy will not be reversed, as it has been so many times in the past, would do a great deal to reduce the uncertainty about the political will and ability to reduce inflation. Such a resolution should acknowledge that this effort began in the Carter Administration and continues in the present Administration. Those members of Congress who see no need to persist in the program of disinflation could vote against such a resolution. But it would provide the

American people with a clearer intent of Congress in supporting or rejecting the long-term efforts, particularly of monetary policy in reducing the rate of inflation.

Monetary policy has been successful in trimming the average rate of growth of money and all money income over the past 3 1/2 years. But it has achieved this slowdown with disturbingly wide swings in the rate of growth of money which were reflected in the performance of the economy. The swings in the rate of growth of money that are troubling are not week to week, or month to month, but those that occurred over six to nine month intervals or, if they were of shorter duration, of unusual magnitude.

Money supply contracted by 9% at an annual rate in the second quarter of 1980. The imposition of credit controls contributed significantly to this decline. It was then followed by an increase of about 15% at an annual rate from early July through mid-December of that year. And from April to October of 1981 there was no increase in the money supply. As a consequence, the economy contracted by slightly more than 1% in money terms and by nearly 10% in real terms in the second quarter of 1980. It then recovered at an extraordinarily rapid rate, culminating in a nearly 20% increase in mney terms and nearly 9% in real terms in the first quarter of 1981. These percentages are all at annual rates. The economy declined in real terms in the second quarter of 1981 by 1.6% at an annual rate, rebounded very moderately in the third quarter and then declined very sharply in the fourth quarter of 1981 and the first quarter of 1982.

What we have is the evidence of volatile money and a volatile economy. The very sharp acceleration in the economy in the second half of 1980 raised inflation expectations particularly in the financial markets but elsewhere as well. It discredited the anti-inflationary economic policies and that damage is still being repaired. So it is highly desirable, in restoring the credibility of policy, to achieve a more stable and persistent path for both money growth and economic growth.

It would be very damaging to the anti-inflationary effort and to the long-term credit markets in particular if monetary policy were suddenly to become highly expansionary in a vain effort to extricate the economy from its present predicament. Some increase in money is desirable, but a sharp and prolonged spurt would be destabilizing.

Focusing on the current situation I would begin by noting the increase in money supply that occurred in October of last year through to mid-January. It grew at an annual rate of about 15%. The economy has yet to reflect the stimulus of that increase. It was muted by the decline in the turnover of money in the first quarter of the year. The secular or normal trend of velocity currently is estimated to be at about 4%. With a return to this more normal velocity, we could expect the economy to grow in money income terms — nominal GNP — at about 9-10% beginning at some point in the months immediately ahead. However, since mid-January there has been no increase in the money supply and were this to persist through the third quarter, the recovery would be stifled. What I am saying is that some increase in the money supply is clearly necessary bringing it along the upper end of the Federal Reserve target path of 5 1/2% from the fourth quarter of last year to the fourth quarter of this year.

It appears that the economy for the month of June was below the average for the second quarter. If July does not exhibit a relatively strong upturn, it will be difficult for the third quarter average of real economic growth to run above the second quarter. Anecdotal information from retailers suggests that July business is not doing very well. To put it into more technical terms, velocity or the turnover of money does not yet appear to be accelerating. Furthermore, it appears that money supply in July is likely to decline unless the Federal Reserve moves more aggressively to reduce the federal funds rate in order to achieve an increase in bank reserves and money. That seems to be happening now with the announcement of the reduction of the discount rate of one half of one percent. It appears that the underlying demand for credit in the economy by all borrowers — households as well as businesses — is diminishing and had the Federal Reserve persisted in pegging the federal funds rate at an unsustainably high level, it would as a consequence have intensified the drag on monetary growth.

Recovery in the economy, incidentally, will help to lower short-term interest rates. Improved corporate earnings and cash flow will diminish the need for leaning heavily on short-term borrowing. It has been particularly distressing to many corporations in this recession that the bond market has been so inhospitable that persistent fears of inflation continue to haunt portfolio managers. The heavy reliance on short-term debt at a time of declining corporate profits has reduced the liquidity of corporations. Prolonged recession would exacerbate this condition and further jeopordize the credit worthiness of many companies. Consequently, economic recovery becomes rather important as we move through the third quarter.

I believe that a recovery will take place. I believe that the velocity of money will begin to increase. Consumption spending will strengthen as the summer ends as a result of increased disposable income arising out of the tax cut, and finally I believe that the monetary authorities will succeed in holding the rate of growth of money at the upper end of their target range. A 5-6% rate of growth of money supply coupled with a 4% velocity should give us 9-10% nominal income. And the persistence of the Federal Reserve in holding to its targets will help to enhance its credibility in the financial markets. If Congress explicitly supports the Federal Reserve in that effort by additional reductions in the federal budget, simultaneously with the recovery, confidence would be greatly strengthened.

Mr. OLSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Olsen.

After listening to a lot of witnesses and reading a lot of statements about monetary policy and the vast differences of opinion that you can get, I'm not really going to delve into where we ought to be and what, exactly, the discount rate ought to be. But I'd like to ask you, Mr. Olsen, if you agree with Mr. Maude and me that, structurally and internally, the nonborrowed reserves, the reporting of M_1 and things that I was complimenting Mr. Maude on because I agreed with him, do you agree that the Fed could do a lot better job specifically in some of the mechanics, and whatever targets they picked and all of that, be able to smooth out the handling of the money supply?

Mr. OLSEN. I do believe that there is more that they could do. In my prepared remarks, partly to be brief, I pointed to the undesirable volatility in the rate of growth of money and the high volatility in the performance of the economy as a consequence over the past 3 years. And I do believe that additional steps taken earlier could well have avoided a good deal of that degree of volatility.

CONTEMPORANEOUS RESERVE ADJUSTMENT

We now expect to see the introduction of contemporaneous or near-contemporaneous reserve adjustment next year. The Federal Reserve has decided to proceed with that. One of the haunting prospects is that some years later we'll look back and it will have made a contribution to a more stable policy and you'll wonder why wasn't it done 2 or 3 years earlier instead of debated for such a long time?

The CHAIRMAN. Yes, I wondered that. You can go back in the hearing records and over and over again, I didn't understand why they were on lagged reserve accounting and didn't go to contemporaneous reserve. I never could get any satisfactory answers. We never did have any witnesses that did not agree that reporting weekly M_1 figures was ridiculous, that they were meaningless, they weren't accurate.

I was at an international monetary conference in London. Everybody I talked to said it's silly and I said, why do we do it? So finally, they've decided they're going to get off that; yet, they haven't implemented it yet. They've announced that they would.

So I don't expect any magic or any great changes as a result of these, but I think that they would be very helpful, at least.

Let me ask you, Mr. Maude, a question. One thing that disturbs me, and you've heard me enough even earlier today saying where I think the major blame is. Without question, it's with the Congress of the United States because the Fed can't fight inflation alone. If we had had a more restrictive fiscal policy, then the Fed wouldn't be a target. Everybody would probably be saying, gee, the Fed has done a marvelous job. They simply have to be coordinated to go hand-in-hand. And yet, over and over again, over the past couple of years, I have had people say, if Congress will just do this. And I'm saying this in the context that we have not done enough.

But in January 1981, no one would have believed that we would take $14 billion out of the 1981 budget and $36 billion out of the

1982 budget. We performed, relatively speaking, far better than anybody else and there was no response.

You can go back to Chairman Volcker before this committee and say, well, if Congress will just do this, then this will happen.

Now as I said earlier, they've all been wrong, but how much is enough? Either one of you can respond. How much is enough to get some response in the market on fiscal policy?

Mr. MAUDE. I think you've got to show direction and I think it's got to be convincing. I think the financial markets have been battered around for so many years with resolutions which, as former Treasury Secretary Simon said, have really never been worth the paper that they've been written on.

It's going to take more than resolutions. It's going to take you more than——

The CHAIRMAN. Let me interrupt you there. I agree. Passing budget resolutions that are not implemented, passing one in the summer of 1980 that said we're going to have a $200 million surplus was nothing but a 1980 election year document. I agree with all of that.

But in this case, there was a difference for the first time in $50 billion of already-appropriated money, not reductions in future appropriations. It had already been appropriated in those 2 budget years and was rescinded.

Now that hadn't happened. So I understand the rhetoric of the years past and the unkept promises over and over again. And if I were in the money-lending business, I'd say, hey, those guys never tell the truth. But we've essentially had no response from a dramatic turn-around, even though not nearly enough. But $50 billion was not a resolution. It wasn't a statement. It was removed from existing budgets.

Mr. Olsen?

Mr. OLSEN. The answer isn't a simple one, but let me go back a little bit in history. Apart from the fact that accelerating inflation over the past 15 years eroded the value of fixed-rate obligations, the acceleration in money growth in the second half of 1980 appears to have been particularly damaging to the credibility of the fight against inflation.

We saw bond prices plummet and long-term interest rates, including mortgate rates, rise very rapidly in the second half of 1980. In the winter of 1980–81, in debates held around the investment policy committees and finance committees of countless financial firms across the country, the dominant view that emerged was that long-term fixed-rate lending had lost its economic legitimacy.

There were explicit decisions to substantially back away from the purchase of such investments, in some cases, in totality. Those resolutions continue to hold at many of those financial firms.

FEDERAL DEFICITS

That was before, incidentally, the size of the present Federal deficits were even known. At that time, the deficits that were then being viewed were somewhere in the neighborhood of perhaps $50 or $60 billion, not well in excess of $100 or $150 billion.

When those budget deficits came along, even though we have had a cooling off of inflation, those budget deficits are being employed to continue to support the argument that fixed-rate, long-term lending has no legitimacy.

The **Chairman**. Let me play the devil's advocate on that point because you know that's what I'm doing because I cannot be considered anything but a fiscal conservative and I'm sure that you're aware of that. My voting records and attitudes on budget deficits have been very clear for a long period of time.

But as a percentage, GNP, all sorts of other measures you want to make, these deficits, in real terms and those relative comparisons, aren't any bigger or as big as many others in past years. And yet, there was not this response then. There was high inflation, higher than now, and bigger deficits, relatively speaking.

And I'm not using that argument to defend these. I'm not one of those who says there's a smaller percentage——

Mr. **Maude**. I think there's one key difference. There is one key difference this time around which is troublesome. In the past, deficits were cyclically-induced and they always occurred the latter stages of a recession and at the beginning of the recovery. Theoretically, even though history doesn't show that it worked out this way, because spending kept on increasing rapidly, but theoretically, as the economy picks up, you could look forward to the possibility of, if not a surplus, at least a dwindling deficit.

Now with the 3-year tax cut in place and with the indexation of tax rates going onstream later on in 1985, now the markets are looking at deficits that are increasing year after year during a period of time when very strong economic growth is projected as well. And that can only bring forth a clash.

The **Chairman**. We've only had a balanced budget once in the last 22 or 23 years. So if they were expecting surpluses, they were awfully naive.

Mr. **Olsen**. Let me offer also an answer to your question. The budget deficits of 1975–76, as ratio to GNP or whatever measure, were as large as the deficit that is occurring this year and would occur next year. We made those relevant measures, incidentally, and we have even made the arguments, pointing out that interest rates fell in 1975 and 1976.

The decline in long-term interest rates in particular in those 2 years, in economists' terms, reflected the fact that portfolio managers had declining inflationary expectations, or at least they weren't increasing. And one of the reasons why was because we came out of the 1974–75 recession with a decision on the part of portfolio managers to increase the proportion of bonds in their portfolios and reduce equities because equities had gone through such a bad time in the 1974 recession.

So they bought bonds for 3 years, raising those ratios and it reflected, in fact, that they weren't that concerned about inflation.

The Secretary of the Treasury in those years had the good fortune of having to finance a deficit into a market that was extremely hospitable in which inflationary expectations were not particularly high because of the recent past history did not give them reason to have a great deal higher inflationary expectation.

The present environment is different. In the present environment, the portfolio managers have very high inflationary expectations. The present deficit has to be financed into a market that is not hospitable at all.

Additionally, as Mr. Maude has pointed out, if I can add one point to it, in the past, either explicitly or implicitly, everybody knew that monetary policy would become more expansionary in order to bring about a strong recovery in the economy. Rising revenues would reduce the deficits. Less well known was that ultimately, inflation and bracket creep would not only diminish the deficits further, but, as a matter of fact, give additional funds to support increased spending very substantially over time.

In this case, monetary policy is clearly committed to a moderate course and will not finance a rapid recovery in the economy in order to cause deficits to melt. And that's something else which the financial markets are aware of.

This fiscal policy hasn't gotten on board to fight against inflation. Monetary policy has. And that's why the financial markets are distressed.

The **Chairman**. Well, I agree with you there. I made that point over and over again, that we have not done our job in Congress, have not done our part in trying to solve the problem.

BALANCING THE BUDGET

But one of you mentioned the tax cuts that are in place. It seems to me that when you're trying to balance the budget, that there are two ways to do it. Obviously, you can cut spending or you can increase taxation. When you're looking at the capital markets, however, and the available venture capital, investment capital, for whatever purpose, it doesn't seem to me to make much difference whether you're out borrowing it, except for the interest cost, or taking it away from the people in the form of taxation.

So to those who want to do away and cut the tax cuts, when even after them, we're still being taxed at one of the highest levels in the history of this country, far higher than traditional levels, that that isn't an answer at all to try and reduce the pressure on the markets because of these large deficits by taking the money out of the pool of available capital through taxation rather than through borrowing.

Now I agree, borrowing is worse, but not a lot. Except for your interest costs, which adds to the deficit. But still, it's not going to be available for long-term capital investments if you're taxing it away.

Mr. **Olsen**. You're absolutely right, Mr. Chairman, and in addition to that, you haven't cut the taxes if you are financing the tax cut with borrowed money. You only cut taxes when you cut spending by the amount that you've cut taxes. You can just as well send the taxpayer a postcard the day after he gets his tax cut and ask him, would you please lend us back the money that we just gave you?

You're absolutely right in your description of that and Congress and the administration, to the degree that they're not reducing the deficit, they really haven't cut the taxes.

And there was another point I mentioned in my——

The **Chairman**. We haven't cut taxes in any event with the bracket creep and the increase in the social security taxes. In real terms we haven't cut them, let alone what you're talking about.

Mr. **Olsen**. Not if you're going to have to borrow the money to finance the deficits over time.

The **Chairman**. Let me ask you this question. What do you think the condition of the economy would be today, regardless of all of the comments that Reaganomics is failing, supply side economics is failing, if we had gone on with that additional $50 billion of spending—and I'm talking about budgets where it was rescinded, where this is not prospective. This was done and those budgets were already there and we rescinded that kind of spending.

What would the economy be like today?

[Pause.]

Ronald Reagan doesn't exist. Supply side economics didn't exist. We just continued on that path, spent that additional $50 billion?

Mr. **Maude**. I was going to say Brazil, possibly, but go ahead.

Mr. **Olsen**. Well, as a matter of fact, your question is fascinating to me because as I heard Senator Riegle and Senator Sarbanes questioning Mr. Weidenbaum so vigorously and characterizing the distress in the economy today, I thought to myself, well, suppose we had not attempted to fight inflation 4 years ago, but instead, we had continued along the path in which inflation was now beginning to accelerate rather markedly, and government spending was now beginning to rise at a rather alarming rate. You were getting above 10 and going toward 15 percent and above.

I wondered if we were holding these hearings today and there had been no change in policy and we would be looking at, say, a 15 percent rate of inflation at the present time and government spending rising at 15 percent plus per year, whether you wouldn't have had cries of distress throughout the country also, particularly by all those people who are on relative fixed incomes, for example.

And in addition to that, with inflation running at that rate, we would have substantially higher interest rates than we have today. They would have been characterized as high nominal rates, but they would have still been very high.

The **Chairman**. I'm not trying to be partisan at all because I don't care who solves the problem, as I've said the last couple of days and many other times—Republicans or Democrats, I'm not much interested in that. But to say that supply side economics is not working, regardless of who proposed it, I happen to think it is, not nearly as well as I would like to. As I said earlier, I'm not happy with 15 percent interest rates and the whole condition of the economy.

But I do sincerely believe that had we not made some of these changes, you would have had far more serious problems as well. And the longer we avoid tackling the problems of the entitlements programs and the transfer of payments because it's not politically possible to do so—I pity future congresses, whether they're controlled by Democrats or Republicans. They will have a problem that can only be much worse than it is today. I don't think there's any doubt about that.

SOCIAL SECURITY PROBLEM

The social security problem itself, forgetting the budget, the solvency issue has to be faced. Sooner or later, the day of reckoning will come. And my colleagues on either side of the aisle that don't even dare mention the word social security, let alone talk about slowing the growth of it, boy, it's going to be a lot tougher—politically, economically, every other way, the longer that decision is deferred.

But I guess politicians, as long as you can postpone something to the future, you'll face it then rather than now, because I think we have an obligation to all those people who are on social security, totally apart from this argument of the overall budget, to make certain that that system is solvent so that they will get their pensions and that generations who are now young and paying these tremendously high taxes to support it, can expect that they will have a pension as well.

The more I study it, I think we can blame the Fed and we can blame Ronald Reagan and we can coin the term "Reaganomics" and I think the major fault has to lie here in the Congress of the United States. And I don't know how anyone can interpret it any other way in light of the facts. The Fed didn't create that trillion-dollar debt. It didn't have anything to do with it at all.

Presidents can recommend. We can blame them for what they recommend, but we don't have to agree with what they recommend.

I get a kick out of blaming this President or any other because of the deficits. I guess it's a tribute to their forcefulness that they just coerced all us independent souls into voting their way because we don't have to when we get over on that floor. We can vote any way we desire if we have the courage to do so.

I just, as I said over and over again, feel very frustrated about the prospects until Congress becomes part of the solution rather than part of the problem because I think that most every other segment of the economy is trying. Management is. Labor certainly has been attempting to contribute to the problem with unprecedented cutbacks in their wages and fringe benefits.

It seems like very part of the team is trying to play, except Congress, and we're going on about our business as usual.

Gentlemen, I don't have any more questions. I do appreciate your patience in waiting so long into the lunch hour. I hope that your stomachs are not growling too badly.

But thank you very much for coming today. The committee is adjourned.

[Whereupon, at 1:07 p.m., the hearing was adjourned.]

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1982

TUESDAY, JULY 27, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D. C.

The committee met at 9:30 a.m. in room 5302, Dirksen Senate Office Building, Senator Jake Garn, chairman of the committee, presiding.

Present: Senators Garn, Riegle, and Proxmire.

The CHAIRMAN. The committee will come to order.

Today the Banking Committee continues the third day of hearings on monetary policy and we are very happy to have before us this morning Beryl Sprinkel, Under Secretary of the Treasury for Monetary Affairs.

Mr. Secretary, we will be happy to hear your testimony at this time.

STATEMENT OF BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Mr. SPRINKEL. Thank you, Senator Garn. It's a pleasure to be with you today to discuss the administration's views on monetary policy.

This administration assumed office with the firm conviction that the process of inflation is a major obstacle to vigorous economic performance and expansion of individual opportunity. As a result, a major part of the President's economic recovery program was the call for a gradual deceleration of monetary growth to a noninflationary pace. The basis of this monetary program was and still is the recognition that sustained inflation—no matter what may be the initiating force—requires the accommodation of excessive money creation.

Since that recommendation was made, monetary policy has become the subject of much public debate and controversy. In the process, the administration's views on monetary policy have sometimes been misunderstood and misinterpreted. Our views are actually very basic and straightforward, so I would like to take this opportunity to restate them as concisely as possible. In addition, I will mention some things that we do not advocate, but which are frequently attributed to us.

VIEWS AND RECOMMENDATIONS

Basically, our views and recommendations can be summarized as follows:

One, the primary cause of the accelerating inflation that has occurred in the United States over the past 1½ decades has been a persistently excessive rate of money growth.

Two, reducing the rate of money growth is essential to controlling inflation.

Three, inflation, and the inflationary expectations that it generates, have been a major factor in the secular rise in interest rates.

Four, since inflation and high interest rates are an anathema to sustained economic growth, noninflationary monetary policy is a prerequisite to restoring the sound economic prosperity that we all seek.

Five, the deceleration of money growth should be accomplished in a gradual, steady and predictable fashion, in order to minimize the economic disruptions and costs associated with moving the economy from an established inflationary path to a noninflationary one.

Now let me mention some views that many are attributing to us that we do not hold:

One, we do not expect the Federal Reserve to achieve precise week-to-week or month-to-month control of the money supply. They do not have the power to do so, and efforts to try to do so would likely prove to be extremely destablizing. We do believe, however, that the Federal Reserve has the ability to maintain the average quarterly rate of money growth within the announced target range.

Two, we do not advocate the use of high interest rates to fight inflation. High interest rates are the legacy of persistent inflationary money growth, not an element of anti-inflationary monetary policy. Stubbornly high interest rates are the inevitable result of letting inflation occur in the first place. A reacceleration of money growth would cause further inflation and guarantee even higher interest rates in the future.

Three, we do not believe that monetary policy is the source of all economic problems, nor is it the cure-all for all ills. Prudent monetary policy is a necessary condition to achieve real economic growth and prosperity, but it is not the panacea.

A year and a half ago we recommended that the rate of money growth be slowed permanently. That recommendation is completely consistent with the stated policies and objectives of the Federal Reserve. The target ranges for 1982, and those which the Federal Reserve has tentatively set for 1983, are appropriate to provide for both economic recovery and continued progress on inflation. The Fed has made significant progress to date toward achieving noninflationary money growth, and we fully support their plan to persevere in that policy. Our support for prudent, noninflationary monetary policy has not changed or waivered.

To the contrary, the progress on inflation over the past year should serve to encourage us all that the ultimate goal of a permanent reduction in inflation is within our reach, if only we continue along the path of a sustained deceleration of monetary growth. But if we succumb to the temptation to declare victory too soon, by mistaking success in the first major skirmish for a permanent routing of the enemy, then we will not only prolong and worsen inflation, but significantly reduce the chances of ever bringing it under control.

While earnest in intentions, those who counsel a return to the quick-fix prescription of easy money are advocating actions that are actually inimical to the very thing they seek—permanently lower interest rates. Faster money growth would soon validate the very fears which have been responsible for the maintenance of high long-term interest rates—fears that the current slowing of inflation will be temporary. While there might be some immediate easing of short-term interest rates in financial markets—and I am not even certain of that—long-term interest rates would soon rise, reducing greatly the potential for future output and employment growth. Periodic calls for the Fed to loosen the monetary spigot also serve to exacerbate the credibility problem.

For this reason, the administration supports the Federal Reserve's decision to maintain the existing money growth targets, rather than giving in to the pressures to revert to inflationary monetary policy. We would hope that the objective of permanent elimination of inflation through a sustained monetary discipline would be a bipartisan, national goal. It should not be allowed to become an issue of partisan politics. Neither the administration nor the Federal Reserve is happy about the level of interest rates, and neither views these rates as a necessary evil in the fight against inflation. However, the solution is not to sacrifice the policy which is in place, but to assure the public that the policy will remain in place.

The record of the 1970's clearly shows that a little more money growth does not provide a lasting increase in production and employment. Any boost to production and employment that comes from accelerating money growth is temporary, while the inevitable permanent effects are inflation and higher interest rates. Accelerating inflation, escalating interest rates, and the resulting deterioration of the incentives to save and invest are, in fact, powerful and pervasive deterrents to sustained growth. Also, it is folly to trust that faster money growth would now result in more production because various segments of the economy are operating at less than full capacity. The experience of the past 15 years should be ample evidence that inflation is not a problem which arises only when the economy is fully employed. Sustainable economic expansion requires a financial system based on a reliable dollar and that means monetary discipline.

GRADUAL DECELERATION OF MONEY GROWTH

To some, perhaps, the administration's repeated call for a gradual, stable and predictable deceleration of money growth may now seem trite or dogmatic. Let me assure you that it is neither. There are very real, very important economic reasons why we have repeatedly made this prescription. That is, a deceleration of money growth that is not gradual, not stable and/or not predictable has very real, adverse economic consequences.

First, let me discuss the importance of a gradual deceleration of money growth. After more than a decade of accelerating inflation and rising interest rates, inflationary expectations had become deeply entrenched in economic institutions and behavior. It would, of course, have been technically possible for the Federal Reserve to reduce money growth abruptly to a noninflationary rate. But it was felt that such a sudden move would cause severe short-term economic disruption and hardship. The gradual approach would provide the public more time to adjust its inflationary expectations downward, thereby minimizing the transitional costs in terms of lower output and higher unemployment. The transition is drawn out by this approach, but the immediate negative impact on real economic activity is reduced. Specifically, we recommended that the rate of money growth be cut in half by 1986—with a steady deceleration each year.

It would be naive to expect that such progress toward a noninflationary economy could be made without experiencing some economic hardship. Some of the disruptions associated with the transition to a noninflationary economy are of course being felt now. These hardships are not to be dismissed. In terms of its implications for the long-run prosperity of the Nation, however, the importance of controlling inflation cannot, in my opinion, be overstated. The hardships are temporary, but the damages of allowing inflation to accelerate would be lasting and pervasive.

The administration realizes that even temporary economic disruptions have real consequences for people here and now. We recognize, however, that many attempts to provide immediate relief ultimately result only in more severe problems. Also, it is a mistake to presume that all problems in the economy are the result of monetary restraint. In many cases, they are more properly characterized as long-term, structural problems that cannot be cured by returning to inflationary money growth. Many of our most serious sectoral problems today reflect the damage of a decade of rising inflation and interest rates; these problems would only be compounded by the resurgence of inflation and further increases in interest rates that would accompany faster money growth. Not only would the trend of unemployment continue upward, the dislocations and economic pain that would accompany the next effort to establish a noninflationary monetary policy would be even greater.

Let me now turn to the importance of stable money growth. I want to reiterate and emphasize that when we say stable money growth, we do not mean precise week-to-week or even month-to-month control. There are too many factors over which the Federal Reserve has no control that cause temporary aberrations in the money stock to expect such precision. However, the Federal Reserve itself maintains that the average quarterly growth of M_1 can be controlled within a band of plus-minus 1 percent. Thus, on a quarterly basis, the Federal Reserve has the ability to keep M_1 within its announced target range. Such stability in money growth would greatly enhance the stability in the financial markets and provide for lower interest rates.

The stability of money growth takes on greater importance when viewed in the context of the record of monetary actions over the past decade and a half. On several occasions since 1965, money growth was slowed abruptly in response to concerns about inflation. But, in each case, the effort was soon abandoned and the rate of monetary expansion subsequently was accelerated further. In each case, the economy suffered the immediate costs of monetary restraint—recession and rising unemployment—but was denied the lasting benefit of reduced inflation. This stop-and-go pattern is, of course, exactly what many are advocating that the Federal Reserve do once more. The result was a steadily rising long-term rate of money growth, punctuated by several short periods of monetary restraint. The rising trend resulted in an ever-worsening inflation and an upward-ratcheting of interest rates, while the brief bouts of monetary restraint generated or intensified economic recessions. These episodes eroded confidence in the willingness or ability of the government to fulfill its promises to control inflation.

This effect on the credibility of anti-inflationary monetary policy is seen clearly in the pattern of long-term interest rates since the mid-1960's. With each stop-go episode, long-term rates became increasingly resistant to the Government's assurances that anti-inflationary policies would be maintained. The lows in long-term interest rates which were recorded near each cyclical trough have risen sequentially with each successive cycle. The reason is obvious—accelerated money growth, renewed inflationary pressures and rising interest rates have followed each recession.

Because episodes of reducing money growth have occurred before, history alone gives the financial markets no assurance that we are witnessing a permanent shift to noninflationary policy. If a period of slow money growth is followed by a long period of rapid money growth—as it was in late 1981 and early 1982—that uncertainty is reinforced. It signals to the financial markets that their worst fears and doubts may be coming true—that the Government cannot be relied upon to adhere to noninflationary monetary policy over the long run; that anyone who bets on inflation coming down and staying down—that is, anyone who lends money at a lower interest rate—can count on losing it to the tax of inflation.

In the current environment of uncertainty and concern about the budget deficit, the effects of volatile money growth are magnified. Hence, the stability of money growth is a particularly important aspect of monetary policy in the current situation. With the experiences of the past decade fresh in the public memory, erratic money growth adds to the uncertainty that noninflationary monetary policy will, once again, not be maintained over the long run. That skepticism helps keep interest rates high, even as actual inflation falls.

A sustained increase in the rate of money growth in the last half of this year or an announced increase in the money growth targets would simply reinforce and justify that skepticism. Discussions, proposals and political pressures to increase money growth have themselves contributed to the problem of high interest rates by adding to the markets' fears.

To repeat, random variations in monetary growth from 1 week or 1 month to another are to be expected, and there is no reason to attempt to offset such changes. The task is to assure that these random changes do not persist and become several months or quarters of very rapid or very slow monetary growth. To the extent, therefore, that the Fed is successful in holding quarter-to-quarter money growth closer to announced target ranges, the credibility of long-term policy is greatly enhanced. The evidence gathered at the Treasury Department indicates that reducing the quarter-to-quarter variability in money growth would give market participants greater confidence about the future and remove one of the factors which has been a source of continued upward pressure on long-term interest rates.

Senator Garn, shortly we will have this study completed and, with your permission, I would like to submit it for the record and it should be in the next few weeks. All the research is completed. We've got some fine-tuning on the words. I think it's important.

The CHAIRMAN. We would be very happy to do that.

[Summary of the study referred to follows:]

August 13, 1982

The Effect of Volatile Money Growth on Interest Rates and Economic Activity:

Summary of a Study*

Four types of policy action are capable, in principle, of reducing market interest rates, to some degree. The four are changes in debt management, reductions in spending or tax changes that reduce future budget deficits, direct controls, and improvements in the conduct of monetary policy. The focus of this study is on the effects of variable monetary growth. The analysis is conducted, however, within a general model of the economy, which incorporates the influence of other factors and the interplay of various factors through the markets for assets, goods, and money. The results presented here were generated from a condensed version of this model. The complete results will be presented in the full technical report.

The principal conclusions of the study, to date, are:

(1) Sustained high variability of money growth has increased uncertainty about the expected return from holding bonds. The study suggests that the market charges a risk premium on long-term bonds of 4% to 6% to compensate for the risk of loss of capital values arising solely as a result of the variability of money growth.

(2) Variability of M1 growth cannot be reduced to zero. If variability is reduced to the level of 1977-79, however, interest rates on long-term bonds would fall 2% to 3%.

(3) Short-term interest rates would be reduced also.

(4) Lower monetary variability should not be accompanied by faster money growth. Faster money growth would certainly raise interest rates. One reason is that market participants would not believe that the

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* This is a summary of a research effort by the Office of Monetary Policy Analysis of the U.S. Treasury, requested by and submitted to Beryl W. Sprinkel, Under Secretary for Monetary Affairs. The research has been conducted by Professor Allan H. Meltzer of Carnegie-Mellon University and Angelo Mascaro of the Treasury Department. The full technical report is in the final stages of preparation.

current reduction in inflation will persist if money growth is reaccelerated. A second reason is that temporary changes in money growth -- up and down -- are a main cause of variability in economic activity, in addition to contributing to risk premiums in interest rates.

(5) Reducing the variability of money growth would reduce the variability of GNP growth. A main finding of the study, replicated for different periods and using different measures of money, is that, on average, Federal Reserve actions have added more variability to the economy than they have removed. The estimates suggest that improvements in the implementation of monetary policy can reduce the magnitude of fluctuations in GNP growth by one-fourth to one-half of their present values.

(6) Much of the increase in variability of money growth since late 1979 comes from two sources. One is the imposition and removal of credit controls in 1980. The other is the monetary control method of the Federal Reserve. The following comparison of money growth, using quarterly average growth (at annual rates) for the period before and after October 1979, shows how much money growth has been reduced, and variability increased, in the recent period.

	11 Quarters Ending September 1979 (1st Quarter 1977-3d Quarter 1979)	11 Quarters Beginning October 1979 (4th Quarter 1979-2nd Quarter 1982)
Average Growth of M1	8.3%	6.3%
Standard Deviation	1.5	5.2
Range for M1 Growth	5.2 to 10.3	-3.1 to +14.8
Average Growth of Monetary Base	8.6%	7.1%
Standard Deviation	1.0	2.7
Range for Base Growth	7.1 to 10.5	1.9 to 10.3
	1980 IV - 1982 II	
Average Growth of M1	5.8	Range: 0.3 to 10.9
Standard Deviation	3.9	
Average Growth of Base	6.1	Range: 1.9 to 10.3
Standard Deviation	3.3	

Interest Rates, Inflation and Monetary Variability

To estimate the effect of monetary variability on interest rates, the sources of change in quarterly values of money and monetary velocity were separated into "predictable" and unpredictable components. The "predictable" components of money growth and velocity are the parts that can be forecast from knowledge of seasonal factors and the past history of each series. The unpredictable, or random, component includes everything else.

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The anticipated rate of inflation is estimated in a similar way.* Anticipated inflation for next quarter is the rate at which prices are expected to rise on the basis of the momentum in the price series and knowledge of seasonal and other factors. The momentum of inflation reflects the maintained rate of money growth, but factors such as sustained shifts in the demand for money can also affect the series. Random and transitory price changes are removed from the measure of anticipated inflation by the procedure which is used.

The rate of interest has four components.

(1) A real rate representing an estimate of the productivity of capital. In the results presented here, the expected return on capital is embodied in the intercept term of the regression.

(2) The effect of anticipated inflation. If there are no effects of taxes and inflation on real rates, anticipated inflation raises market interest rates point for point. Recent estimates for the United States suggest that taxes and other factors reduce the effect of anticipated inflation on interest rates by about one-half. In the results presented here, anticipated inflation refers to the expected rate of price change in the next quarter only.

(3) A risk factor representing the variability of the unpredictable component of money growth.

(4) A risk factor representing the variability of the unpredictable component of monetary velocity. All unpredictable changes in GNP growth, other than those resulting from unpredictable money growth, influence interest rates through this component.

This study indicates that item (3) -the risk premium which is generated by variable money growth -is a principal reason the current "real" rates are considered to be high. The empirical results, using the ten-year U.S. Government bond rate are presented in the following table.

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* The rate of price change is an endogenous variable in the model which is used in this study. Thus, the expected rate of price change should be consistent with the structure of the model, including information about the probable pattern of the exogenous variables. Time series analysis alone is not sufficient to guarantee this result. This shortcoming has been corrected, with no appreciable effect on the results which are presented here. The complete results will be presented in the full technical report of the study.

Interest Rate Equation: Long-Term Interest Rate

Quarterly: 1969Q4 - 1982Q2 51 Observations

Dependent Variable: 10 Year Government Bond at Constant Maturity

Independent Variable	Coefficient	Std. Error	t-Statistic
Constant	3.19347	1.015	3.146
Expected Inflation[1]	0.30238	0.1198	6.780
Velocity Volatility[2]	0.19315	0.0903	2.140
M1 Volatility[3]	0.73328	0.1081	6.780
Rho	0.6222	0.1271	4.897

Summary Statistics
R-Squared: 0.9111
Adjusted R-Squared: 0.9033
F-Statistic (4,46): 117.8
Durbin-Watson Statistic: 2.1042
Sum of Squared Residuals: 27.81
Standard Error of Regression: 0.7775
Q(8 degrees of freedom): 9.355

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[1] Expected inflation is the next period's inflation forecast. The forecast is derived from a time-series model estimated over 1953Q3-1980Q1, ARIMA (0,1,1), on the quarterly logarithmic first-difference of the GNP deflator. Values to 1980Q1 are in-sample estimates, while subsequent values are one-step-ahead forecasts using the ARIMA model.

[2] Velocity volatility is the square-root of the average of the sum of squares of velocity innovations over four periods with a one period delay. The innovations are from an ARIMA (0,1,2) model estimated over 1953Q3-1980Q1, with subsequent values being obtained from one-step-ahead forecasts to 1982Q1.

[3] M1 volatility is the square-root of the average of the sum of squares of M1 innovations over four periods with a one period delay. The innovations are from an ARIMA (1,1,0) model estimated over 1953Q3-1980Q1, with subsequent values being obtained from one-step ahead forecasts to 1982Q1.

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A series of charts show the effects of components (2), (3) and (4) on the ten-year U.S. Government bond rate from 1969 IV through the second quarter of 1981. Each component is multiplied by its estimated effect on interest rates to obtain the contribution of that factor to the interest rate. The solid line in each chart shows the forecast of interest rates based on all four of the factors and the dotted line is the actual interest rate. The broken line in the lower portion of the chart shows the contribution of a particular factor.

Chart 1

Comparison of 10 Year Bond Rate

Estimated Rate from Equation, and

Contribution of Velocity Volatility

actual = dotted line
fitted = solid line
velocity volatility effect=dashed line

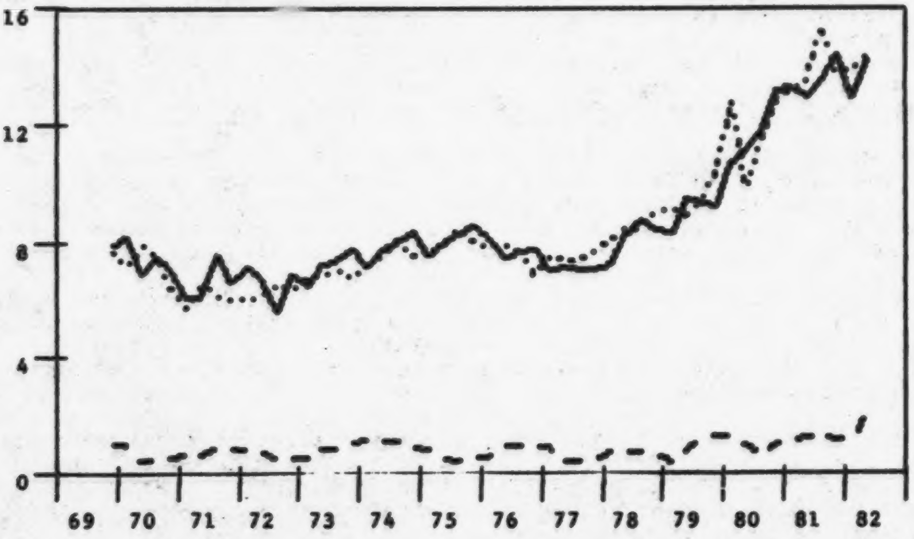

Chart 1 shows the contribution of the velocity effect. The variability of unpredictable changes in velocity contributes between 0.3% and 1.3% during the period. There is a slightly rising trend in recent years. Federal Reserve statements place heavy emphasis on the effects of these changes, but this study suggests that this influence has been relatively small. The most that can be expected from reductions in the variability of the demand for money (or velocity), based on the findings of this study is about 1/2% reduction in long-term rates.

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Chart 2

Comparison of 10 Year Bond Rate

Estimated Rate from Equation, and

Contribution of Monetary Volatility

actual=dotted line
fitted=solid line
M1 volatility effect=dashed line

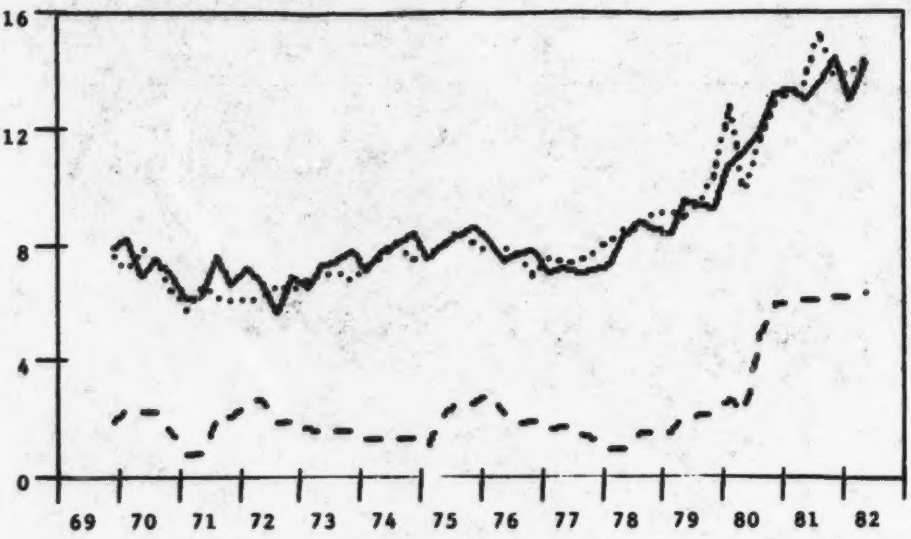

Chart 2 shows the effect of variations in the unpredictable component of money growth -- called M1 volatility on the chart. The effect of M1 volatility on the interest rate can be seen clearly in the peaks reached in 1971, 1975, and 1981 and in the troughs reached in 1972 and 1978. The chart indicates that a return to the lower monetary variability of pre-1979 should be be accompanied by a decline of 3% to 4% in the ten-year bond rate.

A common problem with estimates of this kind, however, is that the very large increase in variability and large increase in interest rates after 1979 might tend to cause an overestimate of the importance of monetary volatility. Therefore, the response was reestimated for the period 1969 IV-79 III. A similar, but lower estimate of the effect of variability, is obtained. Using both estimates, a 2% to 3% reduction in interest rates on long-term bonds is a reasonable estimate of the response to more stable monetary growth.

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Chart 3

Comparison of 10 Year Bond Rate
Estimated Rate from Equation, and
Contribution of Expected Inflation

actual=dotted line
fitted=solid line
expected inflation effect=dashed line

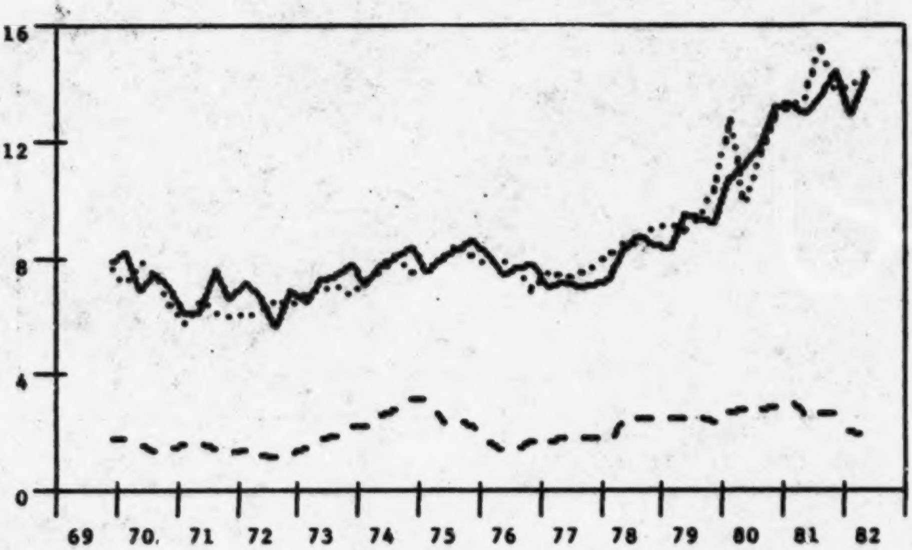

Chart 3 shows the effect of expected inflation. The surge in interest rates from 1972 to 1974 and the decline to 1976 reflects the strong influence of changing expectations of inflation following the removal of price controls, the Soviet wheat purchases, the oil shock and the aftermath of these events.

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The Effects of Less Variable Money Growth on GNP Growth

The Federal Reserve tries to reduce fluctuations in the economy by varying interest rates, reserves and money growth. Their ability to reduce fluctuations is limited, however, by two difficulties. One is the difficulty of producing accurate forecasts, a difficulty shared by all forecasters. The other is the difficulty of knowing whether observed changes in economic behavior are temporary or persistent. Mistaken forecasts and misinterpretations of observed changes would cause the Federal Reserve (and everyone else) to misperceive and misinterpret what is happening. Persistent changes could be treated as temporary or transient; transient changes could be misperceived as permanent. As a result of these, and perhaps other errors arising from efforts to smooth the money market, or from the use of lagged reserve accounting, a complex structure of reserve requirements or inaccurate seasonal adjustment, the Federal Reserve can, in principle, add more variability to the growth of GNP than it removes. Consequently, the Federal Reserve can make "business cycles" worse.

To estimate the amount of variability introduced and the amount removed, the study computes: (1) the variability of the predicted component of GNP growth; (2) the maximum variability in the predicted component that would occur if money growth remained constant; (3) the sum of the predicted and random components -- variability of actual GNP; and (4) the maximum variability of (actual) GNP if money growth remains constant. These calculations are shown in Table 1, columns (1) and (2).

Table 1

Variability of Quarterly GNP Growth with Current Monetary Policy and with Constant Money Growth

(annual rates in percent)

Period	(1) Actual Policy	(2) Constant M1 Growth	(3) Constant Base Growth
1953-80			
Predicted Component	0.9	0.7	0.6
Total GNP Growth	1.9	1.9	1.8
1953-69			
Predicted Component	0.7	0.6	0.5
Total GNP Growth	1.7	1.6	1.6
1969-80			
Predicted Component	3.8	1.8	0.9
Total GNP Growth	5.9	3.9	2.1

Column (3) shows similar calculations with growth of the monetary base constant. Again, these are estimates of the maximum variability. Actual variability would be lower, since reducing uncertainty about monetary growth would reduce the variability of interest rates and the demand for money.

These results indicate that, on average, constant money growth (or constant base growth) would have probably reduced the variability of GNP and, at least, would not have increased it. For the period 1969-80, in which the oil shock and the Government's reaction to the situation had a large negative influence on GNP growth, the reduction in variability of GNP growth is greater than 50%.

These findings suggest that the Federal Reserve operations have increased the variability of economic activity. Less variable money growth, on average, should produce steadier growth in GNP.

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Actual and Potential Control of Money

Last year, the Federal Reserve released a study of monetary control in 1980. According to their estimates, 95% of the time the error in controlling the quarterly (or annual) growth of M1 could be held within ±1%.

Actual control in 1980 -- and in most other years for which the Federal Reserve announced targets -- was much less precise. The actual performance shows an average deviation from target in the range of -2.0 to + 2.5%.

A principal reason for the poor performance is that the Federal Reserve attempts to forecast either interest rates, or the demand for money and credit. Their forecasts are relatively inaccurate, so they introduce large errors into the control procedure. In addition, use of lagged reserve accounting, seasonal adjustment, borrowing arrangements and other procedures also increase variability.

Significant reductions in interest rates and in the variability of GNP can be achieved, if the volatility of money growth is reduced. The size of further reductions in interest rates that can be achieved are approximately:

(a) 1/2% by reducing the variability of monetary velocity;

(b) 3% to 4% by reducing the anticipated rate of inflation.

The latter cannot be achieved entirely in the near term. This study suggests that some reduction in anticipated inflation has occurred, and further reductions are likely this year if money growth is held within the announced target. A reduction in expected inflation to 6% from present levels reduces long-term interest rates by about 1%.

Mr. **Sprinkel.** Thank you, sir.

This leads me to the predictability part of our prescription for monetary policy. To the extent that money growth proceeds in a reliable pattern, uncertainty is reduced and interest rates can fall. In the current environment, the problem of the predictability of future monetary policy is compounded by concern about the Federal budget. The perception of unbounded growth of Government spending into the future raises fears that higher inflation and/or higher tax rates lie ahead.

The financial markets fear that the Federal Reserve will be pressured into monetizing the implied deficit: That is, financing spending by creating new money. These fears are aggravated by congressional statements about the need for faster money growth. Any signals that the Fed is coming under political pressure to revert to inflationary money growth only adds to the concern.

CURB EXCESSIVE GOVERNMENT SPENDING

Both the Congress and the administration, by their actions, must demonstrate to the public that the Federal Government has the collective will to discipline itself now and in the future against the fiscal excesses which have otherwise come to be expected of it. We must face the fact that any Government spending—no matter how well intentioned its goals or beneficial its impact—imposes costs on the economy. In the short term, Government spending can be financed three ways—through taxation, by creating new money or by borrowing. Ultimately, however, only two sources of revenues are available—direct taxation and/or inflation. Therefore, the situation is simply this: If we are to allow Government spending to grow unchecked as it has over the past several decades, we will face accelerating inflation—and the escalating interest rates that go with it—high and rising tax rates or both. There are no other choices and the current situation in financial markets should be heeded as a sign that the public is aware.

Monetary policy issues and its impact in the economy are more complicated than the simple "tight" money/"easy" money characterizations that are commonly made.

The experience of a decade of accelerating inflation and rising interest rates has radically altered the behavior and expectations of the American public. As workers and producers, as savers and consumers, and as borrowers and lenders, our collective behavior has been contaminated by inflationary psychology. The mechanism by which increases in money allowed interest rates to fall, and the economy to expand—which most of us learned in Economics 101—has been shown to be such a simplified view that it is no longer very useful. The public has become so attuned to the long-run relationship between money growth and inflation that those favorable short-run effects of accelerated money growth are increasingly transitory.

In addition, the way in which a given monetary policy is pursued—whether it be "tight" or "easy" in the common parlance—is extremely important. The same monetary policy—in terms of the amount of money growth provided by the monetary authority—can have very different effects on the economy. For example, an annual increase in money of 6 percent has very different economic implications if it results from no growth for 6 months, followed by 12-percent growth for 6 months, instead of, say, 6 months of 5-percent growth and 6 months of 7-percent growth. The ultimate result in terms of money growth would be the same, but the immediate impact on the economy would be radically different.

Recognizing the important economic implications of the pattern of the rate of money growth, the administration recommended, and has consistently supported, not just a deceleration of money growth; while deceleration is vital to controlling, we believe that it is best if that deceleration is achieved in a steady and predictable fashion. We made that recommendation 18 months ago, believing that such a policy would provide the monetary restraint needed to control inflation, but with the least possible disruption of economic activity. That is, given the task of controlling inflation, we believe that that goals could be achieved with the least possible loss of output and employment, if the deceleration of money growth were steady and predictable. No economic event or development in the past 18 months has altered that view and conviction.

Thank you, sir.

[Complete statement follows.]

STATEMENT OF BERYL W. SPRINKEL
UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
WASHINGTON, D.C.

Tuesday, July 27, 1982

Chairman Garn, Senator Riegle, and distinguished Members of the Banking Committee, it is a pleasure to be with you today to discuss the Administration's views on monetary policy.

This Administration assumed office with the firm conviction that the process of inflation is a major obstacle to vigorous economic performance and expansion of individual opportunity. As a result, a major part of the President's economic recovery program was the call for a gradual deceleration of monetary growth to a noninflationary pace. The basis of this monetary program was and still is the recognition that sustained inflation -- no matter what may be the initiating force -- requires the accommodation of excessive money creation.

Since that recommendation was made, monetary policy has become the subject of much public debate and controversy. In the process, the Administration's views on monetary policy have sometimes been misunderstood and misinterpreted. Our views are actually very basic and straightforward, so I would like to take this opportunity to restate them as concisely as possible. In addition, I will mention some things that we do not advocate, but which are frequently attributed to us.

Basically our views and recommendations can be summarized as follows:

(1) The primary cause of the accelerating inflation that has occurred in the U.S. over the past decade and a half has been a persistently excessive rate of money growth.

(2) Reducing the rate of money growth is essential to controlling inflation.

(3) Inflation, and the inflationary expectations that it generates, have been a major factor in the secular rise in interest rates.

(4) Since inflation and high interest rates are an anathema to sustained economic growth, noninflationary monetary policy is a prerequisite to restoring the sound economic prosperity that we all seek.

(5) The deceleration of money growth should be accomplished in a gradual, steady and predictable fashion, in order to minimize the economic disruptions and costs associated with moving the economy from an established inflationary path to a noninflationary one.

Now let me mention some views that many are attributing to us that we do not hold:

(1) We do not expect the Federal Reserve to achieve precise week-to-week or month-to-month control of the money supply. They do not have the power to do so, and efforts to try to do so would likely prove to be extremely destabilizing. We do believe, however, that the Federal

Reserve has the ability to maintain the average quarterly rate of money growth within the announced target range.

(2) We do not advocate the use of high interest rates to fight inflation. High interest rates are the legacy of persistent inflationary money growth, not an element of anti-inflationary monetary policy. Stubbornly high interest rates are the inevitable result of letting inflation occur in the first place. A reacceleration of money growth would cause further inflation and guarantee even higher interest rates in the future.

(3) We do not believe that monetary policy is the source of all economic problems, nor is it the cure-all for all ills. Prudent monetary policy is necessary to achieve real economic growth and prosperity, but it is not the panacea.

A year and a half ago we recommended that the rate of money growth be slowed permanently. That recommendation is completely consistent with the stated policies and objectives of the Federal Reserve. The target ranges for 1982, and those which the Federal Reserve has tentatively set for 1983, are appropriate to provide for both economic recovery and continued progress on inflation. The Fed has made significant progress to date toward achieving noninflationary money growth, and we fully support their plan to persevere in that policy. Our support for prudent, noninflationary monetary policy has not changed or waivered.

To the contrary, the progress on inflation over the past year should serve to encourage us all that the ultimate goal of a permanent reduction in inflation is within our reach, if only we continue along the path of a sustained deceleration of monetary growth. But if we succumb to the temptation to declare victory too soon, by mistaking success in the first major skirmish for a permanent routing of the enemy, then we will not only prolong and worsen inflation, but significantly reduce the chances of ever bringing it under control.

While earnest in intentions, those who counsel a return to the quick-fix prescription of easy money are advocating actions that are actually inimical to the very thing they seek -- permanently lower interest rates. Faster money growth would soon validate the very fears which have been responsible for the maintenance of high long-term interest rates -- fears that the current slowing of inflation will be temporary. While there might be some immediate easing of short-term interest rates in financial markets, long-term interest rates would soon rise, reducing greatly the potential for future output and employment growth. Periodic calls for the Fed to loosen the monetary spigot also serve to exacerbate the credibility problem.

For this reason, the Administration supports the Federal Reserve's decision to maintain the existing money growth targets, rather than giving in to the pressures to revert to inflationary monetary policy. We would hope that the objective of permanent elimination of inflation through a sustained monetary discipline would be a bipartisan, national goal. It should not be allowed to become an issue of partisan politics. Neither the Administration nor the Federal Reserve is happy about the level of interest rates, and neither views these rates as a necessary evil in the fight against inflation. However, the solution is not to sacrifice the policy which is in place, but to assure the public that the policy will remain in place.

The record of the 1970s clearly shows that a little more money growth does not provide a lasting increase in production and employment. Any boost to production and employment that comes from accelerating money growth is temporary, while the inevitable permanent effects are inflation and higher interest rates. Accelerating inflation, escalating interest rates, and the resulting deterioration of the incentives to save and invest are, in fact, powerful and pervasive deterrents to sustained growth. Also, it is folly to trust that faster money growth would now result in more production because various segments of the economy are operating at less than full capacity. The experience of the past fifteen years should be ample evidence that inflation is not a problem which arises only when the economy is fully employed. Sustainable economic expansion requires a financial system based on a reliable dollar and that means monetary discipline.

To some, perhaps, the Administration's repeated call for a gradual, stable and predictable deceleration of money growth may now seem trite or dogmatic. Let me assure you that it is neither. There are very real, very important economic reasons why we have repeatedly made this prescription. That is, a deceleration of money growth that is not gradual, not stable and/or not predictable has very real, adverse economic consequences.

First, let me discuss the importance of a gradual deceleration of money growth. After more than a decade of accelerating inflation and rising interest rates, inflationary expectations had become deeply entrenched in economic institutions and behavior. It would, of course, have been technically possible for the Federal Reserve to reduce money growth abruptly to a noninflationary rate. But it was felt that such a sudden move would cause severe short-term economic disruption and hardship. The gradual approach would provide the public more time to adjust its inflationary expectations downward, thereby minimizing the transitional costs in terms of lower output and higher unemployment. The transition is drawn out by this approach, but the immediate negative impact on real economic activity is reduced. Specifically, we recommended that the rate of money growth be cut in half by 1986 -- with a steady deceleration each year.

It would be naive to expect that such progress toward a non-inflationary economy could be made without experiencing some economic hardship. Some of the disruptions associated with the transition to a non-inflationary economy are of course being felt now. These hardships are not to be dismissed. In terms of its implications for the long-run prosperity of the nation, however, the importance of controlling inflation cannot, in my opinion, be overstated. The hardships are temporary, but the damages of allowing inflation to accelerate would be lasting and pervasive.

The Administration realizes that even temporary economic disruptions have real consequences for people here and now. We recognize, however, that many attempts to provide immediate relief ultimately result only in more severe problems. Also, it is a mistake to presume that all problems in the economy are the result of monetary restraint. In many cases, they are more properly characterized as long-term, structural problems that cannot be cured by returning to inflationary money growth. Many of our most serious sectoral problems today reflect the damage of a decade of rising inflation and interest rates; these problems would only be compounded by the resurgence of inflation and further increases in interest rates that would accompany faster money growth. Not only would the trend of unemployment continue upward, the dislocations and economic pain that would accompany the next effort to establish a noninflationary monetary policy would be even greater.

Let me now turn to the importance of stable money growth. I want to reiterate and emphasize that when we say stable money growth, we do not mean precise week-to-week or even month-to-month control. There are too many factors over which the Federal Reserve has no control that cause temporary aberrations in the money stock to expect such precision. However, the Federal Reserve itself maintains that the average quarterly growth of M1 can be controlled within a band of ±1 percent. Thus, on a quarterly basis, the Federal Reserve has the ability to keep M1 within its announced target range. Such stability in money growth would greatly enhance the stability in the financial markets and provide for lower interest rates.

The stability of money growth takes on greater importance when viewed in the context of the record of monetary actions over the past decade and a half. On several occasions since 1965, money growth was slowed abruptly in response to corcerns about inflation. But, in each case, the effort was soon abandoned and the rate of monetary expansion subsequently was accelerated further. In each case, the economy suffered the immediate costs of monetary restraint -- recession and rising unemployment -- but was denied the lasting benefit of reduced inflation. This stop-and-go pattern is, of course, exactly what many are advocating that the Federal Reserve do once more. The result was a steadily rising long-term rate of money growth, punctuated by several short periods of monetary restraint. The rising trend resulted in an ever-worsening inflation and an upward-ratcheting of interest rates, while the brief bouts of monetary restraint generated or intensified economic recessions. These episodes eroded confidence in the willingness or ability of the Government to fulfill its promises to control inflation.

This effect on the credibility of anti-inflationary monetary policy is seen clearly in the pattern of long-term interest rates since the mid-1960's. With each stop-go episode, long-term rates became increasingly resistant to the Government's assurances that anti-inflationary policies would be maintained. The lows in long-term interest rates which were recorded near each cyclical trough have risen sequentially with each successive cycle. The reason is obvious -- accelerated money growth, renewed inflationary pressures and rising interest rates have followed each recession.

Because episodes of reducing money growth have occurred before, history alone gives the financial markets no assurance that we are witnessing a permanent shift to noninflationary policy. If a period of slow money growth is followed by a long period of rapid money growth -- as it was in late 1981 and early 1982 -- that uncertainty is reinforced. It signals to the financial markets that their worst fears and doubts may be coming true -- that the government cannot be relied upon to adhere to noninflationary monetary policy over the long run; that anyone who bets on inflation coming down and staying down (that is, anyone who lends money at a lower interest rate) can count on losing it to the tax of inflation.

In the current environment of uncertainty and concern about the budget deficit, the effects of volatile money growth are magnified. Hence, the stability of money growth is a particularly important aspect of monetary policy in the currrent situation. With the experiences of the past decade fresh in the public memory, erratic money growth adds to the uncertainty that noninflationary monetary policy will, once again, not be maintained over the long run. That skepticism helps keep interest rates high, even as actual inflation falls.

A sustained increase in the rate of money growth in the last half of this year or an announced increase in the money growth targets would simply reinforce and justify that skepticism. Discussions, proposals and political pressures to increase money growth have themselves contributed to the problem of high interest rates by adding to the markets' fears.

To repeat, random variations in monetary growth from one week or one month to another are to be expected, and there is no reason to attempt to offset such changes. The task is to assure that these random changes do not persist and become several months or quarters of very rapid or very slow monetary growth. To the extent, therefore, that the Fed is successful in holding quarter-to-quarter money growth closer to announced target ranges, the credibility of long-term policy is greatly enhanced. The evidence gathered at the Treasury Department indicates that reducing the quarter-to-quarter variability in money growth would give market participants greater confidence about the future and remove one of the factors which has been a source of continued upward pressure on long-term interest rates.

This leads me to the predictability part of our prescription for monetary policy. To the extent that money growth proceeds in a reliable pattern, uncertainty is reduced and interest rates can fall. In the current environment, the problem of the predictability of future monetary policy is compounded by concern about the Federal budget. The perception of unbounded growth of government spending into the future raises fears that higher inflation and/or higher tax rates lie ahead.

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Summary

Monetary policy issues and its impact in the economy are more complicated than the simple "tight" money/"easy" money characterizations that are commonly made.

The experience of a decade of accelerating inflation and rising interest rates has radically altered the behavior and expectations of the American public. As workers and producers, as savers and consumers, and as borrowers and lenders, our collective behavior has been contaminated by inflationary psychology. The mechanism by which increases in money allowed interest rates to fall, and the economy to expand -- which most of us learned in Economics 101 -- has been shown to be such a simplified view that it is no longer very useful. The public has become so attuned to the long-run relationship between money growth and inflation that those favorable short-run effects of accelerated money growth are increasingly transitory.

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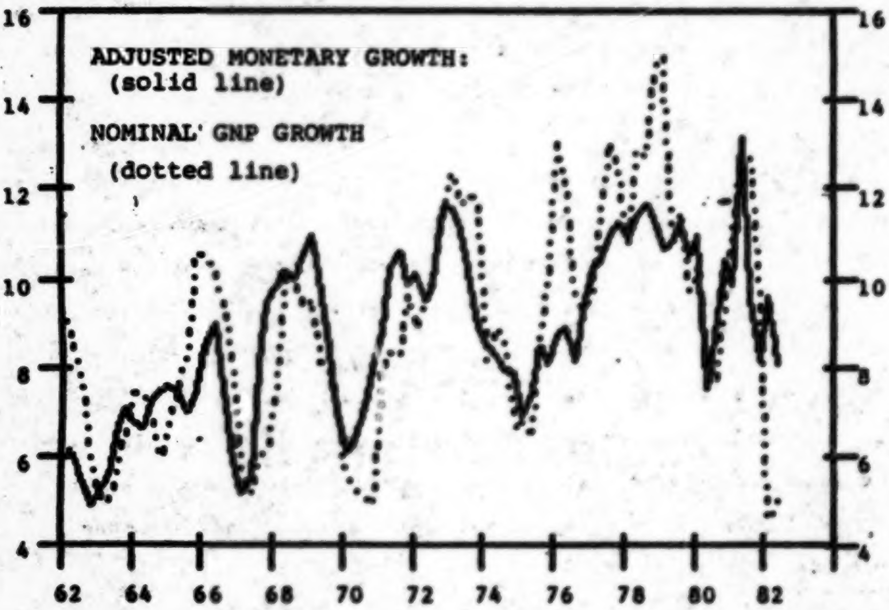
CHART I

Growth in Nominal Gross National Product and Adjusted Monetary Growth



Note: Adjusted monetary growth is the sum of the 4 quarter growth in M1 and the trend growth of M1 velocity; GNP growth is over 4 quarters.

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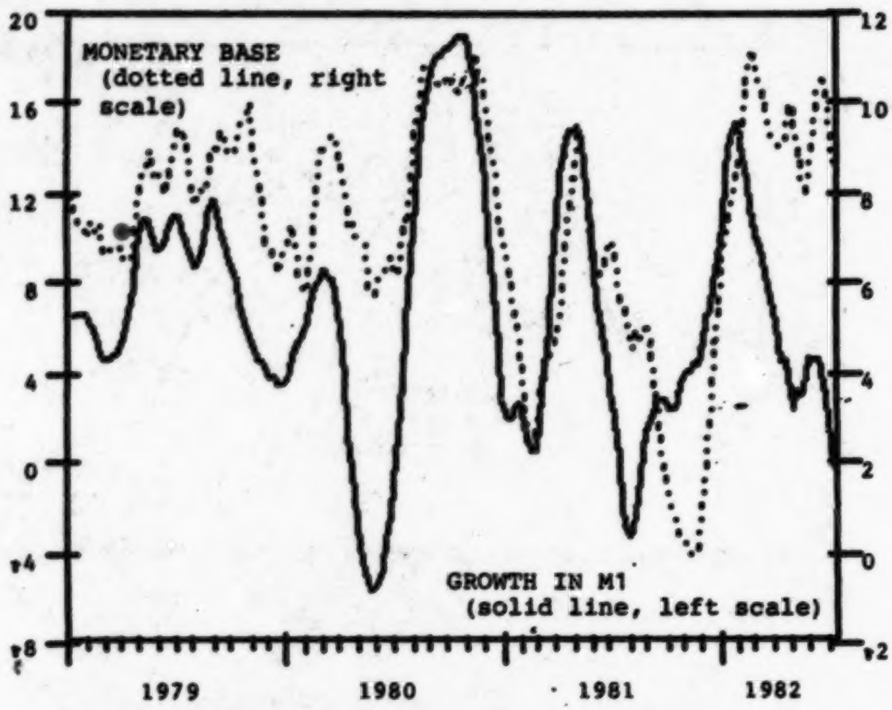
CHART II

Growth in M1 and the Monetary Base



Growth is annualized rate over 13-weeks ago
Data are 4-week moving averages

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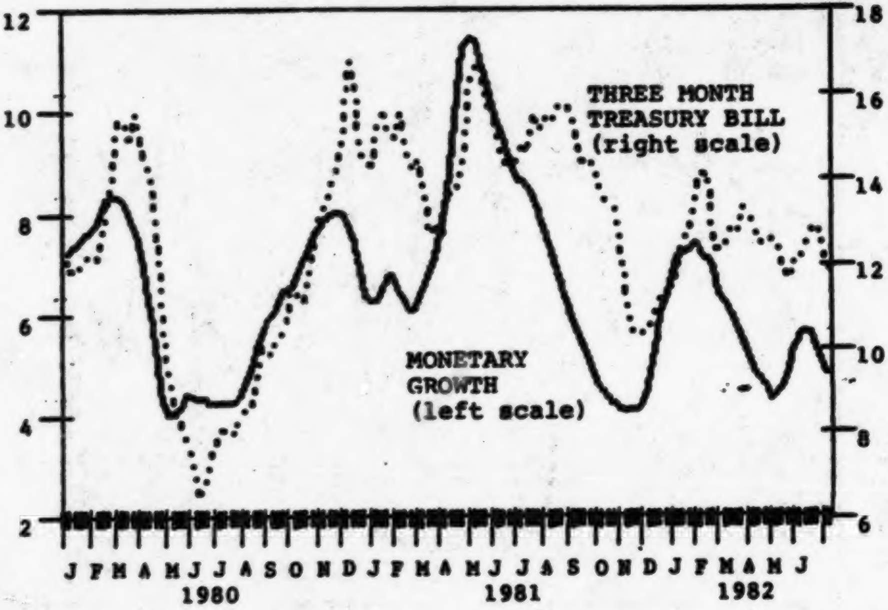
CHART III

Short Term Monetary Growth and
Short Term Interest Rates



Note: Data for M1 are four week moving averages growth is relative to one year ago

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The **Chairman**. Thank you, Mr. Secretary. May I say that I appreciate the directness of your testimony. There has been before this committee a lot of speculation on the administration's position. Is it this or that or something else? After your testimony today, being as specific as it is, there should be no doubt about what the administration's position is on this subject.

Mr. **Sprinkel**. I hope you're right.

The **Chairman**. Well, there are some who will still not want to, but if they read your statement, it certainly could not be considered wishy-washy testimony in any way whatsoever. It is very specific if they care to read it.

In his testimony before this committee last week, Federal Reserve Board Chairman Paul Volcker stated that:

> Periods of velocity decline over a quarter or two are typically followed by periods of relatively rapid increase. Those increases tend to be particularly large during cyclical recoveries.

In your statement today you say while the Federal Reserve cannot control money growth precisely week to week or month to month, growth of the monetary aggregates over a calendar quarter can be controlled.

In controlling money growth over a quarter, to what extent should the Fed make allowances for the quarterly changes in velocity of which Chairman Volcker referred to last week?

PREDICTING MONETARY GROWTH

Mr. **Sprinkel**. I think it's very risky to attempt to, first, predict velocity and then take actions and predict what kind of monetary growth will occur with respect to those velocity changes. We know something about velocity. We know, for example, that it has a cyclical component and also a secular component.

If we refer, for example, to M_1 velocity, we know that the secular trend in M_1 velocity has been approximately 3¼ percent per year on the plus side. We also know that during periods of recession when you look back and compute present velocity at the time, it goes down, just as in periods of recovery it goes up.

To get that average 3¼ or so percent, in the early phase of a recovery it tends to rise at a more rapid rate than 3¼ percent. I can remember a famous debate in this town some years ago when Dr. Burns said that there would be a 5-percent increase in velocity in the first year of an economic recovery and everyone knew that that was wrong except it turned out to be right, and I expect that same sort of phenomenon to occur in the present environment as the recovery gets underway. And I would certainly not believe it would be useful therefore to slow down the rate of money growth because velocity is going to snap back in the early phase of this recovery.

The Federal Reserve can control money growth with some degree of precision. It cannot impact velocity. Velocity is determined essentially by the public and I would hope that the Federal Reserve would set their monetary targets as they have and stick to their course. This means that a given amount of money growth will give you more stimulus when velocity is rising rapidly as it does during the early phase of a recovery, but it also avoids the squeeze later on. If you continue stable money growth you're not likely to get a sharp decline in economic activity subsequently.

The CHAIRMAN. How would you evaluate the Fed's proposal to institute contemporaneous reserve accounting?

Mr. SPRINKEL. I'm very pleased by that move. On prior occasions I have represented the administration's views on what could be done technically to improve the ability of the Federal Reserve to get better control of the volatility of money growth and usually the first prescription mentioned was moving from lagged reserve accounting to contemporaneous reserve accounting. Essentially they have announced they will do that sometime, between now and, hopefully, next spring.

In addition, moving toward a more flexible discount rate policy, that is a discount rate kept in line with the market rates—and there's some evidence they're doing that because they cut the discount rate recently—is, in our opinion, very important.

And the third point that I think is relevant is: To focus on what they can control, namely, total bank reserves or the base. If they do those three things, I'm quite convinced that we'll have reasonably stable growth in money. They have started and we applaud that action.

The CHAIRMAN. How expensive do you think it will be for the commercial banks?

Mr. SPRINKEL. Well, it's going to be costly to some of them. There's no doubt about that. And that was one of the major reasons that many commercial bankers opposed it. There's an easy solution. If we're getting a public benefit out of moving toward contemporaneous reserves, as I believe we are—I think we will all benefit from getting more stable growth in money—it seems to me this should be a public cost, not a private cost. And the way to do that is slightly cut bank required reserves. Bank reserves are a tax and slightly reducing that tax will, of course, offset any added cost. Now there's a question of equity, how much cost each bank incurs in moving toward contemporaneous reserves—but in principle, if we're concerned about the undue cost to banks, then it seems to me that the simple thing to do is to slightly cut reserve requirements and that will offset the increased costs.

The CHAIRMAN. One of our witnesses last week, Donald Maude, from Merrill-Lynch, argued, "reported data on M_1 and M_2 are giving misleading indications as to how restrictive monetary policy has been." With regard to M_1, Mr. Maude argued that NOW accounts have accounted for 91 percent of the increase in M_1 since last October and, two, that most of this growth has represented shifts of savings accounts, not growth of transaction balances.

With regard to M_2, Maude argued that high interest rates have caused interest credited to be a much larger component of the growth in M_2 and that interest credited is not newly created money or enhanced overall liquidity. Adjusting for NOW accounts and interest credited, Maude found M_1 grew at an annual rate of 4.8 percent during the first half of this year and M_2 grew at an annual rate of only 1.9 percent.

Do you believe that because of the arguments made by Mr. Maude that monetary policy may have been far too tight this year?

FEDERAL RESERVE TARGETS

Mr. **Sprinkel**. So far this year, the Federal Reserve is within its targets. Now early in the year, as you know, it was over its targets, but in recent weeks they've moved back somewhere in the upper end of the M_1 range.

Now it's indeed true that as interest rates move around, either up or down, this has an effect on how you and I and others allocate our liquid assets. This is inevitable. This cannot be controlled by the Federal Reserve. It will be controlled by us. Hence, it has an impact on how fast, M_1 and M_2 grow, one vis-a-vis the other.

As I pointed out earlier, I view the trend in bank reserve growth and/or base growth as being much more indicative of whether monetary policy is tight or easy and there is no evidence that I can find based either on the growth in monetary base or in bank reserves that Federal Reserve policy has been unduly tight.

For example, if we take the rate of growth of the adjusted monetary base since last October, the annual rate of growth has been 8.3 percent and that's fairly expansive. There were periods when it was high. More recently it's been lower. But it's averaged about 8 percent.

If, instead of looking at changes in monetary base, you look at what's happened to bank reserves—adjusted reserves—since last October, the growth in adjusted reserves has been 8.1 percent. No evidence, from my point of view, that we have had an unduly restrictive monetary policy, on average, since that time. There has been some volatility in the series and, again, in more recent weeks and months there's been less growth in bank reserves than there was previously, but essentially we've been on a path that leads to expansion in some of the M's, with some changing mix between them. If we are in a pattern of significant further decline in interest rates, I'm sure that the next person that testifies can again point out that there's been a change in the mix, but I think we should not be misled as to whether or not monetary policy has changed.

What the Fed can do is control reserves or the base. They cannot control that mix. Therefore, I think it's very risky to point to changes in the mix and say that Fed policy has been too tight or too easy.

The **Chairman**. Thank you, Mr. Secretary.

Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman.

Secretary Sprinkel, as you know, I have great admiration for you. I've heard you testify before this committee many, many times over the years and in your private capacity at Harris Bank and you're certainly a very able economist as well as a very consistent one.

CONTINUOUS DEFICIT

I didn't hear much or haven't had a chance to see much in your testimony about the role of the deficit in high interest rates. It seems to me that the colossal deficit that the Congress has run over the past 20 years, the fact that we have a trillion dollar national debt, the fact that we face huge deficits this year, as your

Secretary, Secretary Regan, said the other day; next year $110 billion. He hopes in the future it will be less. Many disagree with that and say it might be more.

But it seems to me that that has to be a big element in keeping interest rates high. I don't know how we can avoid that. The Federal Government, as I understand, now takes not the $1 out of $6 it used to take in the early 1970's for example; it takes more than half or is going to take more than half.

Do you feel that this continuous deficit isn't an important role? Is that why you didn't put much emphasis on that?

Mr. **Sprinkel.** Well, I did indicate the disadvantage of sharp increases in Government spending which have been essentially responsible for these recurring deficits. I think it's very important that we get spending under control as your question indicated. I also think it's important that over time we get that deficit under control. It's an unmitigated evil. I can think of no advantages of a large deficit; I can think of a large number of disadvantages.

One part of your question was directed at the relation between the interest rates per se—nominal interest rates I presume you meant, the actual ones that are printed in the newspapers these days—and the size of the deficit. Intuitively, I believe that it has some kind of an impact. I'm quite confident that, other things being equal, the larger the deficit, the higher the real rate of interest. But the problem is, when I try to find support empirically—and we have spent a lot of time at Treasury and I've encouraged some of my friends on the outside to do the same thing—I can't find the empirical support. That doesn't mean it doesn't exist. It may be there, but the effect is faint and it gets swamped by the many other factors that affect interest rates.

Senator **Proxmire.** Let me just ask you, Mr. Secretary, don't you think that the present situation gives you some empirical evidence, the fact that now the deficit is so big the Federal Government is so enormous and interest rates are so unprecedentedly high, just as the level of deficits that we face in the future and have faced recently is almost without precedent.

Mr. **Sprinkel.** Well, that's sort of a self-fulfilling observation, but if it's really true you should be able to find over a lot of time in the past in the United States and in other countries that same relation, and if your staff can find it I'd appreciate it if they'd give it to me.

Senator **Proxmire.** All right. Let me suggest this. In the past there's been the expectation, which is very important as you know in the level of interest rates—the expectation that the deficits are temporary. Often they've been associated with war, for example, which we know we assumed in the past will last 3 or 4 years. That's what's happened. After the war we've had far less—the deficits have dropped very sharply and the demand for Government has dropped sharply.

Now we face the situation where I think many, many investors think this is going to go on indefinitely, maybe 10 or 15 years. It's gone on for 20 now, year after year after year, and they seem to be accelerating. So why wouldn't that be an important factor in investor psychology, particularly on long-term rates, when investors say, "I'm not going to put my money in a 30-year obligation or 20-year obligation because if I do inflation is going to be so high and the demands by the Government for credit are going to be so big that those interest rates are going to continue high.

Mr. **Sprinkel**. I think it is an important factor in the psychology of the marketplace. I can put it in slightly different terms.

Suppose they, No. 1, believe that that deficit is going to persist, as you suggest, and they have every reason for believing it, because it's been around for a long time. We've had a surplus of a half billion dollars or so only 1 year in the last 15 or so. And if they believe that a substantial portion of that deficit is going to be financed with new money—that is, monetary policy is going to accommodate the financing of the debt—then there's every reason to believe that money growth is going to accelerate and therefore interest rates are going to go higher, and therefore should stay high, and not go down.

Conversely, let's suppose the Federal Reserve has at long last convinced all of us that this time they're not going to move back to accelerating money growth, but you still have a big deficit. Clearly, the deficit per se, even if not financed with new money, has an adverse impact on the economy. It absorbs savings, $100 billion plus a year.

On the one hand, we're trying to encourage the Congress and with some success, of adopting laws that will encourage savings, investing, and provide more incentives for work; and then on the other hand, we have a large deficit which is going to absorb those increased savings or existing savings. Therefore, we will not get the shift of resources from consumption toward capital investment and therefore not get a recovery that has in-depth capital formation, resulting in higher productivity improvement. So even if it does not lead to inflationary expectations and therefore higher nominal interest rates, I think there's good reason to believe that it will deter the achievement of our mutual objective of getting healthier economic growth.

So I have no disagreement at all with you concerning the adverse effects of deficits on the economy. The only problem I have is trying to look at data in the past and find a very close relation between the size of deficits and the level of the nominal interest rates.

Senator **Proxmire**. Now I also got the impression from your testimony that you feel that if we are simply steady and persistent, if we stick with the policy of the gradual increase in the money supply and don't depart from it with some kind of quick fix, as you say, that we're going to get things under control.

As I look at it, however, we now have a record, at least the record for the last 41 years, in the percentage of unemployment, 9.4 percent; we have business failures right and left. We have particular difficulty in the credit sensitive industries because interest rates are so high. We're operating, as you know with less than 70 percent of capacity, a very low level on the basis of any historical experience. The credit sensitive industries are even worse off, automobiles operating at less than 50 percent of capacity; homebuilding at far less than 50 percent of capacity.

How far down does the level of capacity have to go before we get some substantial relief here in interest rates? It seems to me that you're saying, "it's all well enough for us to be patient here in Washington," but it's pretty hard to be patient if you're in these industries that are failing, if you're an employer or employee. I just don't get from your testimony any notion of how we can turn this thing around other than just hope that something is going to turn up if we stick with it for another 10 years.

Mr. SPRINKEL. The reason, of course, is that I was addressing monetary policy, not the prospects for the improvement in the economy. The one important change that I didn't hear you mention was the very sharp reduction in the rate of inflation.

Senator PROXMIRE. Until the last 2 months.

Mr. SPRINKEL. Until the last 2 months. The question is which series do you believe, and I guess I don't believe the last 2 months. I do not believe it's 12 percent, just as I didn't believe it was zero percent earlier in the year when the indexes were saying that. I think the inflation is 5 to 6 percent, somewhere in that range.

Now there is no doubt that the economy has gone through a wrenching recession. I just returned from the Midwest, close to your home area, as well as the west coast, and they have a depression in some parts of particular industries, and I certainly have great sympathy for the painful adjustments that are occurring.

GOOD PROSPECTS FOR A RECOVERY

Now the question is, Is there any prospect of a recovery and is it going to be a lasting recovery? I think there are good prospects for a recovery. I've been in the forecasting business for 30 years, until when I came down here. I've been through eight recessions now. Never can one tell with absolute certainty when the turning point has come or the time you know for sure you're well on your way, but you have to watch the odds and the odds certainly have been shifting over the past few months, from my point of view, toward greater probability of recovery. Leading indicators have been up. Money supply, after having very slow growth in parts of last year, has had more growth of late. Inflation rates have come down. We know that as inflation rates have come down that any increase in nominal income will result in some real output growth. We know that the sharp contraction in real GNP in the fourth quarter of last year and the first quarter of this year became a slight positive, 1.7 percent, which is nothing to write home about, but it's certainly better than a sharp contraction.

So that I would say that all the signs point to the probability of a moderate rate of expansion in the months ahead. Now can it be a lasting one, which is another part of your question? It cannot be a lasting one, in my opinion, unless interest rates continue to move down. There has been in the last month or so a very sharp decline in interest rates. Yesterday the prime was cut again in some banks——

Senator PROXMIRE. Short-term rates.

Mr. SPRINKEL. Also long-term rates. They're off about 100 basis points from approximately a month ago. Short-term rates are off more than that, closer to 150 or 175 basis points.

I firmly believe that the probability is that interest rates will continue to move down. If we've got a 5- to 6-percent inflation rate and the world believes it, you and I believe it, and the marketplace believes it and we believe we are going to keep it, that implies interest rates in the 7-, 8-, 9-percent range, not in the 14- to 15-percent range. When we came into office, as you may remember, the prime rate was 21.5 percent. Yesterday some of them moved to 15.5. We expect to see further downward movement, and therefore, if we are to have a sustainable recovery which will lighten the load on those that have gone through this very painful cyclical adjustment, we must achieve further declines in interest rates. That's why my testimony focused on consistency, continuity in both monetary and fiscal policy to convince the marketplace that this time we mean it, so that the downward adjustment in interest rates, which is well under way, will continue into the months ahead.

All the recoveries that I remember were led by consumer spending, not by capital spending. Capital spending comes along 9 or 12 months later, but it's not going to come along if we don't get those long-term interest rates down in the months ahead. I'm confident we will do so, but I don't know for certain.

Senator PROXMIRE. I have one other question, Mr. Secretary. The witness who follows you, Mr. Roberts, has indicated that he thinks that M_1 is a grossly misleading indicator these days because of the change in the way people now keep their cash, keep their liquid assets I should say, and that total net credit would be a far more appropriate target policy and that it ought to be used as an additional target, not the exclusive target but an additional target.

What's your feeling about that?

Mr. SPRINKEL. Well, just as I think it's very difficult for the Federal Reserve to control M_1, M_2, M_3, it's even a greater difficulty for them to control total credit. They can't do it. That is, they have no handle for controlling total credit just as they have not a very good handle for controlling M_1 or M_2.

Senator PROXMIRE. Would you say no handle?

Mr. SPRINKEL. Well, they can affect bank reserves, but there's not a close relationship between changes in bank reserves and changes in total credit. There is a reasonable relation between changes in bank reserves and M_1, but when the public shifts its preferences among the various components of money, as when interest rates move a lot, that relation becomes looser. Now I keep a chart that relates M_1 to total spending and it's a pretty good relation. That is, this is a fairly sensible objective to try to control M_1, but they can't do it with great precision because of the shifts that you referred to. They can control the monetary base and/or bank reserves with precision. There will still be a little noise in the M_s, and ever more noise total credit. But to answer your question precisely, I do not think the Federal Reserve should go even further into the series that they have even less control over and set that as an objective, and how can the Congress enforce someone achieving an objective it does not have the power to achieve?

I would like to see them move back and set their objectives in terms of the series they can control; namely, either bank reserves or the monetary base.

Senator PROXMIRE. For the record, I wonder if you could provide us with a series of options to get interest rates down. You obviously come down very hard and clear on what you feel is the best policy and I'm grateful for that testimony, but I think there may be other options the committee might like to consider because I think all of us are very aware of the fact that high interest rates are at the heart of our problem and we'd like to consider the broadest possible choices. At least this Senator would.

Mr. **Sprinkel**. I'll be glad to think about a few, but the only ones—I have thought about them—and the only ones that I think will really work and continue to work are the policies I have already discussed.

Senator **Proxmire**. That's fine, but you might just mention some of the others and give us a word or two as to why you think they're not appropriate.

Mr. **Sprinkel**. I'll be glad to.

[The following statement was received for the record:]

STATEMENT OF BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS, ON ALTERNATIVE WAYS TO REDUCE INTEREST RATES

(Requested by Senator Proxmire)

Interest rates remain high primarily for two reasons—they contain an expected inflation premium and a risk premium. The route to lower interest rates is therefore, first, to control inflation; that requires noninflationary money growth. Second, the risk premium now contained in interest rates could be reduced steadier and more predictable money growth and if the uncertainties surrounding the growth of government spending and the deficit were reduced.

It is frequently suggested that interest rates could be reduced by either reaccelerating money growth or by some form of direct controls, such as credit allocation or usury ceilings. Increasing the rate of money growth would not produce a lasting decline in interest rates. Any immediate drop in interest rates that might accompany faster money growth would be extremely short-lived; ultimately, faster money growth causes inflation and generates inflationary expectations which causes interest rates to rise, not fall. Inflationary money growth in the past is a major cause of current high interest rates. Reverting to inflationary money growth would only assure that high interest rates will continue into the future.

There is no evidence that direct controls on credit allocation or interest rates would be effective in reducing interest rates in the long run. Such controls may hide the symptom of high interest rates for a time, but they are not a cure for the underlying problem. The experience with credit controls in 1950 is a good case in point: interest rates fell temporarily while the controls were in place, but rose again to new highs once they were removed. In addition, credit and interest rate controls are difficult and expensive to administer, and, by interfering with the normal functioning of the financial markets, cause enormous distortions and inefficiencies in the allocation of credit.

Senator **Proxmire**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Proxmire.

Secretary Sprinkel, I'm sure there will be some additional questions for you in writing. Senator Riegle apologizes for not being able to stay. He's also a member of the Budget Committee and had to attend that other meeting. But I certainly appreciate the directness not only of your testimony but of your answers. We are often accustomed to witnesses, particularly economists, before this committee who are always hedging their answers and it is refreshing to have someone who, as you always have, gives direct responses. We may not always agree, but it's nice to know exactly how you feel and we thank you very much for that.

Mr. **Sprinkel**. Thank you, sir. It's a pleasure to be here.

The **Chairman**.. Thank you very much.

Next I'd like to call to the witness table someone who is used to being on the other side of the table, on this side, Steven M. Roberts, who used to be a staff member of this committee, a very valued staff member. We are happy to have you before the committee today in a different capacity, the other side of the table. We appreciate your willingness to be here and testify, so if you'd like to proceed.

STATEMENT OF STEVEN M. ROBERTS, DIRECTOR, GOVERNMENT AFFAIRS, AMERICAN EXPRESS CO.

Mr. **Roberts**. Thank you very much, Senator Garn. It is a treat to be on this side of the table.

The **Chairman**. And making real money in the private sector, right?

Mr. **Roberts**. You mean what I made when I was on the other side of the table wasn't real money? [Laughter.]

I'm grateful to you and the members of this committee for this opportunity to share with you my views on the conduct of monetary policy by the Federal Reserve. I am here today because of my deep concerns about high and volatile interest rates and their effect on our economy, and about the serious conflicts that exist between fiscal and monetary policies.

MONETARY AND FISCAL POLICIES

Monetary policy is an important element in our overall economic strategy and the Federal Reserve's ability to act flexibly and independently of day-to-day political pressures must be guarded and protected. Fiscal policy is the other important component of economic policy. But, as you well know, it lacks flexibility and political independence, and, more importantly, at this point, credibility. Unfortunately, observers throughout the world do not believe we have the ability to manage our fiscal affairs appropriately. The reaction by our financial markets to the first budget resolution is clear evidence of skepticism in this country with regard to the Congress commitment to reduce spending and deficits. And, the persistence of high real interest rates is a clear signal that our policy mix needs to be changed—fiscal policy is too loose and monetary policy too tight given our current economic conditions and problems.

Looking at the current situation pragmatically, I have serious doubts that genuine substantive changes in fiscal policy can be accomplished until after the elections. At that point the serious questions concerning entitlements and defense spending can be debated in a less politically charged, more rational atmosphere.

But that does not mean that we should sit back and be complacent. Events can be permitted to proceed without additional shifts in policy. In my view this will mean most probably an anemic recovery with the strong possibility that governmental and private credit demands will exceed supply and interest rates will rise as recovery begins, thereby limiting the chance for even moderate economic growth.

I believe that there is an urgent need for the Congress, the administration, and the Federal Reserve to seek innovative ways to restore confidence in our economy and its institutions and to set the tone for releasing the enormous economic strength that this country has hiding underneath the burden of high interest rates and skepticism.

There are things that can be set in motion now that would be very helpful to getting us on the right track.

RECOMMENDATIONS

Specifically, I would recommend the following actions:

First, for monetary policy, I would drop M_1 as an intermediate target for monetary policy because that variable is grossly misleading.

Second, I think the Federal Open Market Committee should immediately adopt a "total net credit" aggregate as an additional target for policy.

Third, the Federal Reserve should immediately bring together senior representatives from the private sector to function like the Committee on Interest and Dividends of the early 1970's—charged with a mandate to come up with specific alternatives to get interest rates down and to reliquify major sectors of the economy.

Fourth, this committee should serve as a catalyst in rebuilding the vitality of our long-term financial markets which are now very, very quietly still. You should undertake an in-depth set of hearings on the problems facing those markets and what can be done to restore their strength.

Fifth, the Federal Reserve should be asked immediately to stop reporting M_1 data weekly and to move ahead quickly with other technical changes to improve the monetary policy process.

With regard to fiscal policy, the time has come for a thorough reexamination of the fiscal policy process, a process that is too big and too complex for piecemeal change. This could be done by the passage of legislation to establish a commission—much like the first Hoover Commission in 1946—to look at ways to make Government more effective.

Second, to increase the credibility of fiscal policy the budget process needs to be improved—a multi-year spending cap to reduce Federal outlays as a share of GNP should be adopted by the Congress now (whether or not the balanced budget amendment to the Constitution is approved).

Finally, while the Hoover-type commission is being organized, the Budget Committees of the House and Senate should set up several specific private sector advisory groups to recommend changes in the budget process by November 30 of this year. There should be individual groups from the business community, from the accounting professions, and other specific constituencies as deemed appropriate. This would allow necessary changes in the budget process to begin immediately with the start of the next Congress.

Rather than going into the details of these points, I'd like to have them included in the record and answer any questions that you might have.

[Complete statement follows:]

STATEMENT OF
STEVEN M. ROBERTS

DIRECTOR - GOVERNMENT AFFAIRS
AMERICAN EXPRESS COMPANY

Thank you, Chairman Garn.

I am grateful to you and the members of the Committee for this opportunity to share with you my views on the conduct of monetary policy by the Federal Reserve. I am here today because of my deep concerns about high and volatile interest rates and their effect on our economy, and about the serious conflicts that exist between fiscal and monetary policies.

Monetary policy is an important element in our overall economic strategy and the Federal Reserve's ability to act flexibly and independently of day-to-day political pressures must be guarded and protected. Fiscal policy is the other important component of economic policy. But, as you well know, it lacks flexibility and political independence, and, more importantly, at this point, credibility. Unfortunately, observers throughout the world do not believe we have the ability to manage our fiscal affairs appropriately. The reaction by our own financial markets to the first budget resolution is clear evidence of skepticism in this country with regard to the Congress' commitment to reduce spending and deficits. And, the persistence of high real interest rates is a clear signal that our policy mix needs to be changed -- fiscal policy is too loose and monetary policy too tight given our current economic conditions and problems.

Looking at the current situation pragmatically, I have serious doubts that genuine substantive changes in fiscal policy can be accomplished until after the elections. At that point the serious questions concerning entitlements and defense spending can be debated in a less politically charged, more rational atmosphere.

But that does not mean that we should sit back and be complacent. Events can be permitted to proceed without additional shifts in policy. In my view this will mean most probably an anemic recovery with the strong possibility that governmental and private credit demands will exceed supply and interest rates will rise as recovery begins, thereby limiting the chance for even moderate economic growth.

I believe that there is an urgent need for the Congress, the Administration, and the Federal Reserve to seek innovative ways to restore confidence in our economy and its institutions and to set the tone for releasing the enormous economic strength that this country has hiding underneath the burden of high interest rates and skepticism.

There are things that can be set in motion now that would be very helpful to getting us on the right track.

Specifically, I would recommend the following actions:

- For Monetary Policy

- Drop M-1 as an intermediate target for monetary policy -- that variable is grossly misleading.
- The FOMC should immediately adopt a "total net credit" aggregate as an additional target for policy.
- The Federal Reserve should immediately bring together senior representatives from the private sector to function like the Committee on Interest and Dividends of the early 1970's -- charged with a mandate to come up with specific alternatives to get interest rates down and to reliquify major sectors of the economy.
- This Committee should serve as a catalyst in rebuilding the vitality of our long-term financial markets by undertaking in-depth hearings on the problems facing those markets.
- The Federal Reserve should be asked immediately to stop reporting M-1 data weekly, and to move ahead quickly with other technical changes to improve monetary policy.

- For Fiscal Policy

o The time has come for a thorough re-examination of the fiscal policy process, a process that is too big and too complex for piecemeal change. This could be done by the passage of legislation to establish a Commission -- much like the first Hoover Commission in 1946 -- to look at ways to make government more effective.

o To increase the credibility of fiscal policy the budget process needs to be improved -- a multi-year spending cap to reduce Federal outlays as a share of GNP should be adopted by the Congress now (whether or not the Balanced Budget Amendment to the Constitution is approved).

o While the Hoover-type Commission is being organized the Budget Committees of the House and Senate should set up several specific private sector advising groups to recommend changes in the budget process by November 30 of this year. There should be individual groups from the business community, from the accounting professions, and other specific constituencies as deemed appropriate.

Let me now turn to a more detailed discussion of each of these points.

First, the narrowly defined money stock -- M-1 -- has serious definitional and prediction problems because of NOW accounts and other financial innovations that make interpretation of observed changes difficult at best. Therefore, M-1 should be dropped as an intermediate target for monetary policy. It makes no economic sense for the FED or anyone else to focus attention on a variable whose definition is changing by actions in the market almost daily, whose behavior is impossible to predict, and whose relationship to income, employment, prices, and trade is uncertain.

I am not alone in this recommendation. In fact, Frank Morris, the President of the Federal Reserve Bank of Boston and a member of the FOMC, has also made this same point publicly. For many years the relationship between M-1 and each of the final targets of monetary policy, namely, income, employment, prices and trade were fairly close and predictible. However, during the mid-1970's circumstances began to change and such changes have continued. The changes were brought about by three events -- continued high inflation rates, continuing high interest rates, and financial deregulation.

Innovation in financial markets is extremely fast. New financial products such as overnight repurchase agreements, money market funds, Eurodollars, NOW accounts, money market funds, and cash management accounts are appearing with increased frequency as individuals and corporations seek to earn a market rate of return on liquid assets. These important and popular money substitutes cannot be incorporated into the definition of M-1 quickly enough to maintain the meaningfulness of that aggregate. Indeed, the appropriate definition of money -- M-1 in particular -- has proven to be quite elusive. Recall the FED's attempts to have two different M-1 variables several years ago. I think they used the names "M-1A" and "M-1B". Last year the FED used a variable that was called "M-1 shift adjusted". Thus, the FED has recognized that there are significant problems with the M-1 concept. But nevertheless, FED policy continues to focus on what is a very misleading variable.

Deregulation has already complicated the fomulation of monetary policy based on changes in growth of the monetary aggregates. With additional financial deregulation being considered the situation will get even worse. Here is what one senior staff member of the Federal Reserve Board's Division of Research and Statistics recently said:

> As you know, monetary policy formulation is now keyed to selecting targets for growth in the monetary aggregates that are expected to produce certain results in terms of income, output, prices, etc. Deregulation, especially of the terms of deposit liabilities may well complicate this process by changing the relationship of income to money -- defined to include primarily some collection of deposit liabilities. As early as 1978, the creation of the 6-month MMC, by reducing constraints on the availability of

> mortgage money at S&Ls, probably meant more income could be financed at higher interest rates with the same level of money. More recently, the nationwide spread of NOW accounts last year induced shifting of funds into these accounts, which are included in narrow money--M1, from savings accounts and other non-M1 sources, thereby distorting the relationship of M1 growth to income flows. The Federal Reserve made some rough adjustments to our data to take account of these shifts, but these adjustments were not fully understood or accepted by many observers of monetary policy, and they probably did not raise the level of comprehension of monetary policy by the general public. Moreover, reflecting their use as a savings vehicle, deposits in NOW accounts this year do not seem to have behaved exactly as funds held in demand deposits used to, further complicating monetary policy formulation. More generally, as deposit categories are deregulated, their character may change, and with this change policy makers would no longer be able to rely on historic relationships in evaluating their choices. These problems may be most acute in the transition phase to a new deposit structure-- as they were last year with NOW accounts-- but they are likely to persist as a byproduct of deregulation for some time.

If the above statement by the Federal Reserve's own staff is accurate, and I believe it is, not only is M-1 a very misleading indicator of policy at this time, but more importantly all of the monetary aggregates must be interpreted with extreme caution. During what may be a lengthy transition period reliance solely on monetary aggregates as short-term indicators of FED policy should be avoided.

I agree with my monetarist friends who say that over the long-term, that is over the full course of the business cycle, it is important to maintain growth in the monetary aggregates at rates consistent with reducing inflation. This must, however, be done in an intelligent manner. It does not mean that the FED should be slaves to M-1, or any other aggregate, on a week-to-week basis, or even on a month-to-month basis. Technical complexities and market induced changes in the definition of what money means to those who use it cannot be easily incorporated into monetary aggregate measures or targets. Furthermore, we have seen recently that changes in velocity in the short-run can be very misleading and in some circumstances could result in faulty policies.

During this transition to a deregulated financial environment monetary policy will continually be grasping at the appropriate monetary target variables. I recommend that the FED look at all available indicators not just the monetary aggregates. Other useful indicators should include: intermediate targets such as nominal and real interest rates and net total credit, or the ultimate objectives themselves, income, employment, prices, and trade. The FED should be asked to explain their policies in terms of the affect they have on these variables as well as on the monetary aggregates.

Several people, including Secretary Sprinkel have recommended that the Federal Reserve adopt the monetary base or nonborrowed reserves as a target variable. I believe that there would be serious problems with this. First, both of these variables should be viewed not as targets of monetary policy, but rather as instruments of policy that might be used to attain the intermediate target objectives. Instruments and targets are two different things. Second, the monetary base is composed of two parts -- currency and nonborrowed reserves. Changes in currency are beyond the control of the Federal Reserve, they represent a derived demand. Whenever a bank is in need of currency it can be obtained from a Federal Reserve Bank, most often by a debit to their reserve account. While the FED could take additional action to offset the demand for currency it is questionable that they should do so in all instances. Third, the FED is already using nonborrowed reserves as its instrument variable, and adjusts changes in the instrument according to changes in economic and financial conditions as they occur.

Second, the Federal Reserve for its part must recognize that credit availability and growth are just as important as monetary growth. Doctrinaire monetarism is coming under increasing question both here and abroad. The FOMC should be asked to immediately hold public hearings on the advisability of establishing as one of its intermediate targets total net credit -- the outstanding indebtedness of all U.S. nonfinancial borrowers. Their present credit aggregate-- bank credit -- is seriously inadequate because it represents only a small portion of the total. Establishing a target for total net credit, moreover, would be entirely consistent with the objectives and requirements of the Humphrey Hawkins Act.

During the past several years an increasing number of well qualified observers of monetary policy have recommended to this and other Congressional Committees that the Federal Reserve adopt a more useful credit aggregate target than the one they currently use -- bank credit. Unfortunately, the FED has only paid lip-service to such recommendations, or has argued that they cannot control anything but bank credit.

According to Professor Benjamin M. Friedman of Harvard University, based on a variety of methodological approaches, total net credit in the United States bears as close and stable a relationship to U.S. nonfinancial activity as do the more familiar asset aggregates like the money stock. Friedman's research has shown that the U.S. nonfinancial economy's reliance on credit, scaled in relation to economic activity, has shown almost no trend and very little variation since World War II. Secular increases in private debt have largely mirrored a substantial decline (relative to economic activity) in federal government debt, while bulges in federal debt issuance during recessions have mostly had their counterpart in the abatement of private borrowing. This type of stability would make total net credit a useful target for monetary policy. Henry Kaufman of Salomon Brothers has indicated much the same thing in testimony before this committee some years ago. So that you have the full benefit of his views I have attached to my testimony a piece of recent testimony given by Professor Friedman. I recommend it to you.

Having a broad credit aggregate as an intermediate target for monetary policy would have the added benefit of bringing into clear focus the effects that borrowing by the Federal government, directly and indirectly through Federal credit programs, has on the availability of credit to the private sector. The large deficits this year, and projected for the next several years, will, given a fixed supply, put upward pressure on interest rates since rates are the "main" allocator of credit among competing users. I emphasize the word "main" because the Federal government does have a unique position as a borrower.

Third, the Federal Reserve should immediately establish a Committee to function like the Committee on Interest and Dividends, which was important during the early 1970's, for holding down interest rates. Since the shift in the Federal Reserve's policy strategy in October 1979 interest rates have been set primarily, and credit allocated, by participants in financial markets. Therefore, participants in financial markets must also take on some additional responsibility for the economic well-being of this country. Individual companies will act in the short-run in their own best interest and in ordinary circumstances they should. However, circumstances are now such that participants in financial markets must be brought together and they must act collectively to get interest rates down in the long-run best interest of the country. This can be done by private initiative without resorting to mandatory controls, but rather voluntarily with some input from the Federal Reserve. We in the private sector can no longer enjoy the luxury of merely sitting back on the sidelines carping about policy-makers' dilemmas.

Everyone is asking a very pertinent question about monetary policy: What can be done to get interest rates down so that the economy can be revived? Chairman Volcker's response to this question has been that the FED has little leeway to act. We can, of course, debate whether this is true. But, as long as the Board thinks this is true they will be reluctant to act.

Some observers have suggested that credit controls be used to do what the FED cannot or will not do. The politics of current circumstances preclude this type of action. I think it highly unlikely that the President will ask for credit control authority to be restored and thus I consider the issue dead.

However, this does not preclude the Federal Reserve or the Administration from turning to the private sector for voluntary action, nor does it preclude the use of "jawboning", a tactic that has been successful in similar circumstances in the past.

During the period of Nixon wage and price controls the Committee on Interest and Dividends was created to advise the Federal Reserve on ways to keep interest rates down. One suggestion that was made by the CID and adopted by many banks was to have their prime rates set according to formulas linked to their cost of funds. While the exact formulas differed many banks set their prime 3/4 to 1 percentage point above the cost of funds. While circumstances differ now, I think similar innovative suggestions would be found by senior financial executives that would result in a significant lowering of the prime and other short-term rate in very short order. But, this and similar initiatives must come from the private sector with guidance from either the FED or the Administration. No lender will voluntarily reduce their spreads unless they have good reason to believe that their competitors will do likewise. I am confident that if something akin to the Committee on Interest and Dividends was re-established tomorrow that additional innovative ways to lower interest rates through private sector initiatives could and would be found.

Fourth, the potential loss of our long-term bond markets should no longer be ignored. It would be a serious mistake to permit all borrowing to be concentrated in short-term instruments which can be subject to significant internal and external shocks. As more and more financing is done short-term, fluctuations in short-term interest rates will reach every nook and cranny of the economy quite quickly, which may be neither desirable nor healthy for the long-term. This committee should immediately undertake a broad set of hearings designed to understand the problems in long-term markets, what they imply for the future of our financial system, and possible approaches to infusing new life into those markets. It would be a serious mistake to let those markets evaporate, which is exactly what has happened in Europe.

This issue needs little further explanation. A story in last Friday's Washington Post explains the situation very clearly, and therefore, I have attached a copy of it to this testimony. Investors and borrowers have avoided the long-term bond markets for some time for two reasons: the high costs of borrowing long, and uncertainty about the future. As a result corporations have turned to short-term sources of funds for both liquidity needs and perhaps even to finance needed investments. Many corporate treasurers are taking this approach in anticipation that rates will drop and that they then can find more permanent financing at more favorable rates.

But, what are the implications for the long-term markets if rates do not fall or worse yet rise and stay high? Will the long-term markets be lost forever or for an extended period of time and will all financial decisions in the future be based on short-term or floating rate credit? What would the implications of this be for future investment spending? What dangers does this pose for stability of financial markets? These are important questions that should not be avoided. This is why I urge this Committee to hold comprehensive oversight hearings on this issue as quickly as possible.

Fifth, the Federal Reserve should move quickly to put in place several technical changes in its procedure that it has recently indicated it will make and should also consider several others. Important changes in the reporting of weekly M-1 data and reserve accounting have been announced but not implemented. The FED should also consider linking the discount rate to market rates and staggering reserve maintenance periods. Both of these latter changes would tend to smooth interest rate movements.

This committee has been instrumental in getting the FED to consider changes in the reporting of weekly M-1 data and lagged reserve accounting. Although the Board has approved in principle these changes they have yet to be put in place. While the Board should be complimented for their decisions, they should also be urged to move ahead quickly to implement those decisions. I would also note that I think the Board has not gone far enough on its decision about weekly M-1 data. Consistent with my recommendation that M-1 be dropped as a target variable I think that the Board should publish M-1 only once a month.

It is my understanding that the Board is now considering an additional change to the maintenance of required reserves. This change would basically divide those institutions required to hold reserves into two groups, and would have each group report in alternate weeks -- thus the term, "staggered reserve periods". This would be a significant and useful change because it would permit banks in one group to provide excess reserves to banks in the other group, thereby reducing the variability in interest rates that occurs now as all banks scramble to meet their reserve requirements on the same day.

I would also suggest that the discount rate might usefully be tied to market rates of interest once the FED moves to a contemporaneous reserve system. This would make changes in the discount rate more frequent. And, although the FED would lose the so-called "announcement effect" that changes in the discount rate now have, that loss would be small by comparison to the gain in control of reserves. Consideration should also be given to making the discount rate a penalty rate during periods when additional restraint is needed.

Sixth, to further the possibility for credible changes in fiscal policy and the budget process, a bi-partisan body of knowledgeable persons, much like the original Hoover Commission in 1946, should be established by law. In fact, this process has already been set in motion. Last year Senators Roth and Eagleton introduced S. 10 in the Senate and Congressman Bolling introduced H.R. 18 in the House to create a Commission on More Effective Government. The mandate given by the legislation could and should focus on the fiscal policy process in general, and the budget and appropriations processes more specifically.

The idea for such a Commission has been endorsed by the President. I understand that S. 10 has been passed by the Senate by a vote of 79 to 5, but that H.R. 18 is still pending in a House Subcommittee. I would urge you and your colleagues to ask the House to move ahead with its consideration of H.R. 18 or S. 10 as quickly as possible. The Commission's work may take eighteen to twenty-four months so additional delays in its formation could be costly.

I admit that the challenge that faces us, and I mean that collectively, to control Federal spending is immense. But it is not beyond our capacity to get tough on spending. However, the Balanced Budget Amendment to the Constitution, if it is adopted, is no panacea. Additional approaches to deal with the problem, such as a legislated spending cap with appropriate changes in the Budget Act to make it effective and credible, can be constructed and enacted.

I need not get into this issue in much detail, because the members of this committee are more aware than I about the public perception of fiscal policy and the budget process. Steps need to be taken now to give the congressional budget process more credibility. The best way to do this is to show signifcant self-restraint, not just once but over a period of time. The FED by adhering to targets that it has set during the past several years has shown that this approach works to restore credibility. The Congress can do the same, but again time is of the essence.

Attached to my testimony is a draft proposal for a Joint Congressional Resolution that may be useful in this regard. It proposes five year goals for reducing Federal outlays as a share of GNP. While this is not a new approach, it is timely. The Chairman of my company, James D. Robinson III, has been discussing this type of resolution with various members of Congress, the Administration, and the business community. It has been well received, not because it is a cure-all for our fiscal problems -- it is not -- but because it represents a starting point for changes in the budget process. Also attached is a short talking paper explaining the need for this type of approach.

Some type of credible action to reform the budget process is needed now. The financial markets would react favorably to such a meaningful and credible commitment to reduce federal outlays over the next several years. The establishment of goals to accomplish such reductions would be useful, but only if the goals are adhered to by the Congress. This will require changes in the Budget Act to establish such goals and to put in place a mechanism for adhering to the goals.

Seventh, credibility in fiscal policy needs to be established and it cannot wait for an amendment to the Constitution to be enacted and ratified by the states. The Congressional Budget process needs to be improved and a firm, believable commitment made by the Congress immediately to make needed changes. This commitment can be made now by resolution or law establishing as a Congressional goal the reduction of total federal outlays as a share of gross national product over the next five years, say to 20 percent or less or some other appropriate percentage. Other changes in the budget process such as the establishment of a credit budget, the establishment of a capital budget, the establishment of a multi-year budget (say for two years), a 2/3 vote for any budget resolution, a line item veto for the President, and other ideas should be explored.

Finally, while the idea of a Hoover-type Commission works its way through Congress and the process of organization, the appropriate Committees of the Congress should continue to work on reforming the budget process.

To further the possibility for credible changes in the budget process non-partisan, non-political private sector advisory groups should be established to recommend changes to the appropriate committees of the Congress. If the private sector, and especially the financial markets are concerned about fiscal policy, federal spending, and federal deficits they should do their part in recommending useful changes in the process. This would be yet another example of private sector initiative and should include representives of financial markets, the business community, accounting firms, and other important constituencies. These advisory groups should be formed quickly and given a short time frame within which to make their recommendations, so that changes in the budget process can proceed to be considered as soon as the 98th Congress begins its work.

Thank you.

The Washington Post BUSINESS

Friday, July 23, 1982

Companies Rushing to Borrow Funds

By James L. Rowe Jr.
Washington Post Staff Writer

NEW YORK, July 22—Companies have been rushing to sell short-term bonds and notes during the past few weeks in a frantic attempt to take advantage of the sharp decline in interest rates.

The list of companies that have sold what analysts say is more than $1 billion this week and last reads like a who's who of corporate America: Du Pont, Ford Motor Credit, Caterpillar, General Mills, Getty Oil, Mead, Champion International.

At 5:25 p.m. today, BankAmerica Corp., which owns the nation's second-biggest bank, announced that it was selling $300 million in notes.

But with rare exceptions, most companies that would have sold 20-year bonds five years ago are selling notes that mature within five years or less, according to Bernard Harmon, vice president of the brokerage firm Drexel Burnham Lambert Inc. "The window is open, but it's open a crack," he said.

Most companies are reluctant to sell debt securities (such as notes and bonds) that mature in more than 10 years because, even with the steep fall in interest costs during the past four weeks, rates remain historically high.

Furthermore, potential purchasers of long-term bonds still are averse to buying them, remembering that in all previous "rallies" since the [illegible] interest-rate siege began four [illegible] ago, sharp declines in rates [illegible] quickly followed by returns to re[illegible] highs.

Investors who bought during the rallies were left with securities [illegible] less than their face value when [illegible] rose again.

See COMPANIES, C12, Col. 1

COMPANIES, From C9

But James W. Simpson, managing director of industrial finance for Merrill Lynch White Weld, the investment banking arm of the nation's biggest securities firm, said investors are starting to get interested in buying longer-term securities.

"For the first time in a year," Simpson said, "the yield curve is positive." That means an investor gets a higher return for a 20-year bond than for a six-month note. When short-term rates are higher than long-term rates, there is no reason for an investor to take the risk of putting funds out for a longer period.

And Henry Kaufman, the oft-quoted economist for Salomon Brothers whose forecasts are closely watched, is predicting today that short-term interest rates will decline further. He also says those declines probably will be short-lived.

But long-term investments still are not attracting investors or issuers and, in the early stages of the rally, many companies are selling notes with a new gimmick: extendability.

For example, Caterpillar Tractor sold $150 million of three-year extendable notes that carry a yield of 14¾ percent to start. At the end of three years, investors can redeem them or extend them for another three years at an interest rate set by a formula tied to other interest rates. The final maturity of these notes will be 1997.

BankAmerica's so-called money multipliers are the equivalent of so-called zero-coupon bonds. Instead of receiving interest every quarter or every six months, investors pay a price less than face value and receive the full amount of the note at maturity. The notes will pay $1,000 at maturity. An investor who buys a money multiplier that matures on Dec. 15, 1987 pays $500. For a note that returns $1,000 on June 22, 1993, an investor pays $250 today.

William Keneisel, a principal of the investment banking firm Morgan Stanley & Co., said that companies, for the most part, are using the funds they raise in the bond market to pay off short-term borrowings from their banks or in the commercial paper market. The bank prime rate, for example, is 16 percent.

Rates have plummeted in recent weeks, according to William Sullivan of the Bank of New York, because recent declines in the money supply have permitted the Federal Reserve to loosen its monetary policy.

Best Available Copy

July 14, 1982

TESTIMONY BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

Benjamin M. Friedman

Professor of Economics
Harvard University

A CREDIT TARGET FOR MONETARY POLICY

Mr. Chairman:

I am grateful for the opportunity to review with this committee the proposal for an alternative monetary policy framework that I presented to it almost a year ago. During the past year, as the U.S. economy has undergone its second business recession of the 1980s, monetary policy has been more than ever the focus of national attention. As people have continued to examine closely the course of monetary policy and its impact on economic events, they have increasingly begun to question not just the specific stance of monetary policy at any time but also the operating framework that defines U.S. monetary policy. In particular, many people have questioned whether the framework now in use, which centers on specific target rates of growth for the monetary aggregates, is the best way to conduct monetary policy today. I believe that this more fundamental concern is highly appropriate, and I hope that the committee's inquiry into possible alternative targets for monetary policy will further the prospects for a serious evaluation of this issue — and, if a sufficient consensus emerges, for actual reform. I am honored to take part in this discussion.

I believe that reform of the U.S. monetary policy framework is now overdue; that the exclusive emphasis on monetary aggregate targets has outlived its usefulness; and that a broader framework, based on both money and credit, would be more appropriate in today's economic and financial environment. Specifically, I propose that the Federal Reserve System adopt an explicit two-target framework in which it would focus both on the money stock and on the quantity of credit outstanding. I believe that a two-target money-and-credit framework for monetary policy would be more likely to achieve the objectives of economic growth, economic stability and price stability that both the Congress and the American public seek.

In this testimony I will first review several factors that account for the recent widespread disillusionment with the monetary target approach which now dominates U.S. monetary policy making. Next, I will outline the basic idea underlying the use of an intermediate target for monetary policy, and state four important criteria for choosing such a target. I will then say why, on each of these four criteria, credit is just as good a target as is money. Finally, I will outline the two-target money-and-credit framework that I have proposed, and explain why it is likely to be superior to the current money-only framework.*

The Disillusionment with Monetary Targets

Monetary aggregate targets have occupied center stage in U.S. monetary policy making in recent years. The Federal Reserve System first used such targets in a formal way in 1970. In 1975 the Congress passed House Concurrent Resolution 133, requiring the Federal Reserve to formulate monetary policy in terms of specific money growth targets to be reported to Congress in advance, and in 1978 Congress reinforced this requirement under the Humphrey-Hawkins Act. In October 1979, the Federal Reserve publicly reaffirmed its commitment to monetary aggregate targets, and adopted a bank-reserves operating procedure for seeking to achieve them.

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*In what follows I will draw heavily on several of my recent papers, especially "Time to Re-Examine the Monetary Targets Framework" (New England Economic Review, March/April, 1982) and "Monetary Policy with a Credit Aggregate Target" (forthcoming in the Journal of Monetary Economics, available now in mimeo). See these two papers for further detail, including supporting evidence on the comparisons between money and credit.

Several strands of economic opinion and analysis, shared in varying degrees among people concerned with monetary policy, apparently led to this focus on monetary aggregate targets. One was the belief that the supply side of the U.S. economy was essentially stable, and that economic fluctuations were due mostly to instability in aggregate demand which a more stable money growth rate could help avoid. Another was the widely perceived problem of determining how any given level of interest rates would affect the economy, as rapid and volatile price inflation made "real" interest rates ever more difficult to measure; by contrast, measuring "money" was supposedly straightforward. Still another was the increasing focus on price inflation itself as a major economic policy problem, together with the belief (apparently supported by the then available evidence) that the rate of money growth placed an effective ceiling on the economy's inflation rate. Finally, a matter of importance at least to economists was the belief that behavior in the economy's financial markets, including especially decisions by households and businesses about how much money to hold, was more dependably stable than were important aspects of behavior in the economy's product and factor markets.

No doubt other influences, perhaps including political and even personality factors, were also at work in bringing about the adoption of the monetary targets framework during the 1970s, but this set of ideas probably comprised the central thrust of that important development. Each of these propositions, if true, would have represented a significant argument in favor of the use of monetary targets, and the joint validity of all of them would have constituted an overwhelming case for that way of designing and carrying out monetary policy.

Regardless of whether or not the best possible assessment of the available evidence actually supported these propositions at that time (a question which in hindsight people may debate without limit), they do not appear consistent with the facts today. The experience of the 1970s, and of the 1980s to date, has sharply contradicted each of them. Oil shocks and agricultural price shocks have powerfully illustrated the importance of instability on the economy's supply side as a cause of economic fluctuations. As financial market participants have shown their innovative skills by developing a wave of new financial instruments and new ways of using old ones, measuring "money" has become anything but straightforward. Price inflation has been able to outpace by substantial margins the ceiling supposedly set by money growth rates, at least for several years at a time. And economists' historical relationships describing the public's demand for money have all but collapsed.

For all of these reasons, today's disillusionment with the monetary targets framework for U.S. monetary policy is not simply a matter of unhappiness over the economy's recent performance. After all, any specific adverse economic experience could be due to either poor policy decisions or poor execution, or even bad luck, rather than an inadequate framework. The desire for change today is instead more fundamental, and therefore more persuasive. The well understood propositions that would favor the exclusive reliance on monetary aggregate targets, if they were true, just do not match today's environment.

Using and Choosing Monetary Policy Targets

Central banks have often found it useful to formulate and implement monetary policy by focusing on some intermediate target or targets. Under an intermediate target strategy, the central bank specifies some financial variable(s) — in the United States today, the major monetary aggregates — to stand as proxy for the real economic targets at which monetary policy ultimately aims, such as economic growth, price stability, employment, and international balance. The result is, in effect, a two-step procedure. The central bank first determines what growth of the intermediate target is most likely to correspond to the desired ultimate economic outcome. It then sets some operating instrument over which it can exert close control — in the United States either a short-term interest rate or, since October 1979, the quantity of reserves — so as to achieve that growth rate for the intermediate target itself.

The essence of the intermediate target strategy is that, under it, the central bank is required to respond quickly (and fully) to any information reflected in the movements of whatever the intermediate target happens to be. Under the current framework in the United States, with monetary aggregates used as the intermediate targets, any movement in the public's money holdings immediately creates a presumption that the Federal Reserve System should react. In principle the Federal Reserve is always free to change the money growth targets, of course, but in practice it is typically reluctant to do so. The intermediate target strategy instead calls for actions aimed at regaining the stated targets, so that the economic signals contained in movements of the monetary aggregates create a presumption of immediate response. By contrast, the presumption of this strategy, strictly implemented, is that there will be no response to signals arising from other sources but not reflected in the intermediate targets.

If the intermediate target strategy with the monetary aggregates as the central targets is faulty, what should the Federal Reserve do in its place? One plausible response to the changed circumstances I have summarized above would be to reject the usefulness of any intermediate target at all for monetary policy. Without an intermediate target, the Federal Reserve would focus its policy directly on the nonfinancial economy — which, after all, constitutes the ultimate reason for having a monetary policy. Such a direct approach may well constitute the most effective policy framework, and an informed public discussion of the idea would be highly useful. Even so, a practical assessment of the situation suggests that, at least for the immediate future, both the Congress and the Federal Reserve itself are firmly committed to having some kind of intermediate target to facilitate monitoring monetary policy on an ongoing basis. Today's hearing on alternative targets for monetary policy appears to be in this spirit.

The question at hand, then, is to choose some alternative intermediate target to use in addition to (or perhaps even instead of) the monetary aggregates, as a focus of monetary policy. To be sure, an enormous variety of financial variables is available for this purpose. The problem is not just finding potential targets but identifying targets which, if used, would lead to a superior performance for monetary policy.

The structure of the intermediate target strategy itself suggests four important criteria for choosing such a target. First, and most obviously, the target should be closely and reliably related to the nonfinancial objectives of monetary policy. Second, movements of the target should contain information about the future (or current but not readily observable) movements of the nonfinancial objectives of policy. A close relationship per se is necessary but not sufficient to make a useful target. Third, the target must be closely related to the operating instruments which the central bank can control directly — in the U.S. context, once again, either reserves or a short-term interest rate. There would be little point in having an intermediate target that the central bank could not reasonably expect to affect within some time horizon like a calendar quarter or a half-year. Fourth, data on the target must be readily available on a timely basis.

These four criteria will largely determine the suitability of any financial variable — including the monetary aggregates as under the current framework, or a credit aggregate as I have proposed, or any other alternative that the committee wishes to consider — as an intermediate target for monetary policy.

Evaluating Credit as a Monetary Policy Target

I have proposed a credit target for U.S. monetary policy because I believe that at least one specific credit aggregate, total net credit (the outstanding indebtedness of all U.S. nonfinancial borrowers), satisfactorily meets each of the four criteria I have stated above. Before proceeding to such a conclusion, it is essential to ask at the outset, "satisfactory" in comparison to what? Because the current framework used by the Federal Reserve System relies on monetary aggregate targets, the immediate standard required to support a proposal for change is that the proposed new target must meet these four criteria at least as well as do the monetary aggregates that are the current focus of monetary policy. I believe that total net credit does meet each of these four criteria at least as well as the monetary aggregates.

First, results based on a variety of methodological approaches consistently indicate that total net credit in the United States bears as close and as stable a relationship to U.S. nonfinancial economic activity as do the more familiar asset aggregates like the money stock (however defined) or the monetary base. Moreover, in contrast to the familiar asset aggregates, among which there appears to be less basis for choice from this perspective, total net credit appears to be unique in this regard among major liability aggregates. Unlike the asset aggregates, the stability of the relationship for total net credit does not just represent the stability of a sum of stable parts.

Because this first criterion for selecting a monetary policy target is the one that always receives the most attention, and rightly so, it is worth reviewing the relevant evidence with some care. The U.S. nonfinancial economy's reliance on credit, scaled in relation to economic activity, has shown almost no trend and but little variation since World War II. After falling from 156% of gross national product in 1946 to 127% in 1951, and then rising to 144% in 1960, total net credit has remained within a few percentage points of that level ever since. (The yearend 1981 level was 143%.) Otherwise it has exhibited a slight cyclicality, typically rising a percentage point or two in recession years (when gross national product, in the denominator, is weak) and then falling back. Although the individual components of this total have varied in sharply different directions both secularly and cyclically, on the whole they have just offset one another. In brief, the secular rise in private debt has largely mirrored a substantial decline (relative to economic activity) in federal government debt, while bulges in federal debt issuance during recessions have mostly had their counterpart in the abatement of private borrowing.

For purposes of monetary policy, however, what matters is not just stability in the sense of zero time trend but stability in a more subtle (and, importantly, a dynamic) sense. Empirical analyses relying on several different methodologies — ranging from comparisons of "velocity" ratios, to comparisons based on detrended data, to "predictive" performance in regression equations explaining the variation of nominal income, to more complicated analyses based on bivariate and multivariate vector autoregression systems — all show that the relationship between total nonfinancial debt and economic activity is fully as stable and regular as is the relationship for any of the Federal Reserve's standard "M" aggregates (on either the pre- or post-1980 definitions) or the monetary base.

Further, the stability of the credit-to-income relationship is a phenomenon in no way restricted to the United States in the post World War II period. The U.S. nonfinancial economy's reliance on debt relative to economic activity has shown essentially no trend over the past 60 years. (The 1921 level was 142%.) Nonfinancial borrowers' outstanding debt rose significantly in relation to gross national product only during the depression years 1930-33, when the economy was deteriorating rapidly and many recorded debts had defaulted de facto anyway. Otherwise the postwar stability in the United States appears to be continuation of a pattern that dates back at least six decades. Among foreign economies, analysis of post World War II data thus far has demonstrated a similar comparability of the credit-to-income and money-to-income relationships in Britain, Canada, Germany and Japan. In sum, there is ample ground for believing that total net credit is as closely related to nonfinancial economic activity as is any of the monetary aggregates that are so central to today's monetary policy framework.

Second, the finding that the credit-to-income relationship is as regular and as stable as the money-to-income relationship would be of little interest in a monetary policy context if the economic behavior underlying these results were such that money "causes" income while income in turn "causes" credit. The evidence contradicts that notion, however; indeed, if anything, they suggest the opposite. The relevant causal links between financial and nonfinancial economic variables appear to be highly complex, but results based on econometric exogeneity tests show that money and credit play roughly parallel roles, with credit somewhat more significant than money in determining the variation of either real income or prices. Still further results of decomposition of variance, based on a variety of different statistical specifications so as to avoid spurious conclusions, suggest not only that current movements of financial variables do contain potentially important information about future movements of nonfinancial economic activity but also that credit contains more of such information than does money.

Third, while it would be difficult for the Federal Reserve System to exercise very precise control over the total net credit aggregate over short time horizons, recent experience has demonstrated that the monetary aggregates are not easy to control either. What matters for the choice of monetary target variable, once again, is the comparison of money and credit. Evidence based on both quarterly and monthly regression relationships suggests that, if the Federal Reserve chose to pursue a total net credit target, it could achieve a degree of control over that target fully comparable to what is possible for the major "M" aggregates. The exact comparisons differ according to the time horizon used for judging successful control, and also according to whether the operating instrument the Federal Reserve used would be nonborrowed reserves (as since October 1979) or the federal funds rate (as before that date). In sum, however, the evidence is consistent with the Federal Reserve's being able to influence a total net credit target, via either a reserves or an interest rate instrument, in a way that is at least comparable to its influence over the monetary aggregates.

Fourth, any intermediate target procedure based on a credit aggregate target would be useless if the relevant credit data were not readily available on a within-quarter basis. Although the standard vehicle in which the Federal Reserve publishes data on the total net credit aggregate is the flow-of-funds accounts, a publication which appears only once per quarter, the great bulk of the underlying data are actually available monthly. As of yearend 1980, for example, the toal net credit measure for the United States was $3,907.5 billion, of which $3,486.6 billion, or 89%, consisted of items regularly reported each month. Somewhat ironically, most of the items not currently reported on a monthly basis are the lending activities of various components of the federal government itself. Of the $420.9 billion of 1980 yearend total net credit not reported on a monthly basis, $352.6 billion represented credit advanced directly by the U.S. Government or by its sponsored credit agencies and mortgage pools. If the federal government were merely to comply itself with the reporting requirements it already imposes on the private sector, therefore, more than 98% of the total net credit aggregate would be available monthly. Moreover, even without any extra reporting effort, the credit data currently available on a monthly basis comprise an aggregate that fully meets the first three criteria for choosing a monetary policy target. The correlation between the complete total net credit series and what is now available monthly is very high (.99985), and the sum of what is available monthly exhibits just as close a relationship to nonfinancial economic activity as does the complete series.

In sum, total net credit, measured by the outstanding indebtedness of all U.S. nonfinancial borrowers, meets each of the four criteria for choosing a monetary policy target at least as well as do the monetary aggregates.

A Proposal for a Two-Target Money-and-Credit Framework

I therefore propose that the Federal Reserve System adopt an explicit two-target framework, in which it would focus both on the money stock and on the quantity of credit outstanding. The Federal Reserve should pick one monetary aggregate, presumably M1, and one credit aggregate, total net credit; specify target ranges for both; and provide the quantity of reserves (or set a short-term interest rate) aimed at achieving these two targets. A deviation of either money or credit growth from its respective target range would then constitute a signal warranting reassessment of that reserve provision path (or interest rate level).

One potential difficulty in implementing this hybrid money-and-credit framework is a problem inherently associated with any policy of pursuing two targets instead of one. What if both targets are not simultaneously achievable? For all practical purposes, however, the Federal Reserve's current policy framework already suffers from just this problem, as the experience of M1 and M2 during 1981 demonstrated. If only M1 had mattered, the Federal Reserve would have had to conclude early on that its policy was too restrictive in relation to the specified target. By contrast, if only M2 had mattered, it would have had to draw the opposite conclusion. In resolving these conflicting concerns, the Federal Reserve had to decide on the relative importance of M1 and M2, and to determine why one was growing more slowly than anticipated and the other more rapidly.

A two-target framework based jointly on money and credit would in part have the same features. If money and credit were both growing in line with their respective targets, then the Federal Reserve would judge the prevailing reserve provision path (or short-term interest rate) to be appropriate. If both were above target, then the implication would be to slow the provision of reserves (or raise the interest rate). If both were below target, the implication would be to speed the reserve provision path (or lower the interest rate). If one were above target and one below, however, then — just as now, with an M1 and an M2 target — the Federal Reserve would have to assess which was more important under the circumstances, and determine why one was moving in one dirction and one in the opposite direction relative to their respective stated targets.

The key advantage of an explicit two-target framework based on both money and credit, in comparison to a two-target approach based on two separate definitions of the money stock, is that it would draw on a more diverse information base to generate the set of signals that presumptively matter for monetary policy. Money is, after all, an asset held by the public, and each monetary aggregate is just a separate subtotal of the public's monetary assets. By having an M1 and an M2 target, as at present, the Federal Reserve is relying solely on the asset side of the public's balance sheet but adding up those assets in two separate ways. By having a money target and a credit target, the Federal Reserve would create a presumption of responding to signals from both sides of the public's balance sheet. The evidence that is now available indicates — not surprisingly, on some reflection — that both sides of the balance sheet do matter.

This two-target money-and-credit policy would require no legislation. On the contrary, the Humphrey-Hawkins Act directs the Federal Reserve to specify a target for credit growth as well as for money growth. In practice, however, the Federal Reserve has typically specified such a target but then ignored it. Moreover, it has chosen to focus only on credit extended through the banking system, which the available evidence indicates is far from the best source of information about the economy, even from within the liability side of the public's balance sheet. Nothing in the legislation, however, requires that the Federal Reserve place its primary emphasis on money to the exclusion of credit, or that it focus only on bank credit among the available credit measures. In a legislative sense, therefore, a two-target money-and-credit framework would simply have the Federal Reserve be even-handed within the requirements already laid down by the Humphrey-Hawkins Act.

In conclusion, I will simply restate my belief that a two-target money-and-credit framework for monetary policy would be superior to the current money-only framework, and that, over time, a monetary policy based on both money and credit would be likely to help achieve a more satisfactory performance of the American economy — to the advantage of all.

* * *

Mr. Chairman, thank you for the opportunity to present my views to this committee.

June 25, 1982

A PROPOSAL FOR FISCAL RESPONSIBILITY AND LOWER INTEREST RATES

I. The Dilemma:

- Fiscal policy is too loose and monetary policy too tight.
- The 3-5 year outlook is for budget deficits perhaps averaging $200 billion a year.
- Interest rates are far too high. Not since the Civil War have real rates of interest been this high.
- Politics make any meaningful budget compromise unlikely. There is no probability that entitlements will be touched until after the November elections.
- Absent any meaningful change in the intermediate term outlook for budget deficits, the securities markets will not recover and interest rates will remain excessively high.
- High U.S. interest rates have led to an over valued dollar. High U.S. interest rates are causing interest rates offshore to remain higher than local economic conditions warrant. This in turn has had a serious negative impact on most foreign economies.

- Most expect recovery later this year. Few think it will be strong or sustainable because of the conflict between tight monetary policy and the pent-up demand for credit.
- If fiscal policy remains out of control, rates won't fall much and the recovery will be short lived. Further, the next cycle will begin with historically high interest rates.
- Most observers expect consumers to lead us out of recession. Their ability to do so is reduced if interest rates are high and credit is not available. (At these real rates of return, the incentive for consumers to stay in short term investments is substantial.)

II. The Conditions and Outlook

- Inflation is down considerably
    - energy prices have fallen and are unlikely to rise much over the next 18-24 months (barring serious problems in the Middle East)
    - food is plentiful and retail prices look relatively stable
    - wage settlements are starting to be made on a much more realistic basis

- Unemployment is high; especially in certain industries and regions, and among minority groups and the young
- Overall, plants are operating at, postwar lows, 70% of capacity or less
    - Many product, commodity, and service prices are falling and there is very little possibility for the markets supporting much in the way of price increases.
- Most capital investment projects and much investment spending is being deferred, reduced or eliminated. Businesses are focusing on remaining liquid or in a number of instances remaining solvent under the burden of high borrowing costs.
- The financial markets appear to be in a fragile condition, with almost all borrowing concentrated in the short-end and no activity at all in the long-term bond market. Maturities and exposure continue to pile up.
- A number of companies -- large and small -- will be put out of business. Bankruptcies are occurring at record rates. If the system causes good companies, not just the inefficient, to go up, then there is something wrong with the system.

III. Proposal: Demonstrate a credible resolve by Congress to get spending under control.

1. Pass a Spending Ceiling Bill. Congress should take immediate steps to pass a Congressional resolution that would impose an aggregate cap on federal government spending for five years (three would be a minimum). This could be as a % of GNP and/or a maximum allowable annual rate of growth. The resolution should proscribe and call for a permanent amendment to the Budget Act of 1974 early in the next Congress establishing multi-year spending goals. This would:

   - clearly reflect to the business and financial world that fiscal policy is headed in the right direction
   - allow the Fed to ease monetary policy
   - create pressure for restraint in government spending that heretofore has been provided by tight monetary policy (i.e., some say high interest rates are needed to force fiscal responsibility; this would be a more liveable substitute)
   - By focusing on aggregate spending as a share of GNP, the political issues of which program

(entitlements vs. defense vs. tax increases, etc.) are avoided until after the election....as they will be anyway.

- be an important step toward materially lower interest rates

2. Use such a move by Congress to
   - Encourage the Administration to be realistic about the need to tackle entitlements and defense -- with the President in a strong leadership role.
   - Encourage the Fed to materially ease monetary policy. (This move by Congress -- if strong enough to represent a credible beginning to more responsible fiscal policy -- can give the Fed an acceptable reason to change their policy.)
   - Encourage business and labor to lobby within their own ranks for a slowdown in price/wage increases.
3. In view of current economic conditions and the outlook I think we have a window of opportunity whereby the Fed should change direction and increase the money supply with an objective of inducing substantially lower interest rates.

- Lower interest rates would take the pressure off operating margins -- this removes temporarily the need for price increases. Most manufacturers are operating at such low utilization rates their motivation is to sell product, not to increase prices.
- Substantially lower interest rates would allow the "re-liquification of America." One of the substantial problems existing today is the level of exposure of many companies to short term debt maturities. A downward move in interest rates would allow refunding and re-spacing of maturities, and increase profit margins.

4. A number of people will violently object to such a move by the Fed. Comments will be made that the Fed has lost its backbone, returned to whipsaw management, buckled under the pressure of Congress or the Administration, etc. It will be claimed that this will lead to renewed and substantial inflation.
   - In my view, economic conditions will not permit this to happen. There is very little opportunity in the marketplace to increase prices in the near term. Conversely, substantially lower interest rates offer the

opportunity to get companies back into a sound, liquid condition. Improved liquidity plus lower cost of capital should restore their interest in bringing capital projects back on stream.

- Some will claim that the long markets will not respond. Investors have been burned before and such a move by the Fed would be a clear signal they would be burned again. I challenge this because any substantial downward move on short rates will ultimately bring long investors back into the market. Bond portfolio managers cannot afford to watch rates move materially lower without being enticed into the longer markets. I believe traders and speculators will provide the short term momentum that will then attract the more permanent investors. In addition, the spending cap will send a positive signal to the markets regarding fiscal policy.

5. In conclusion, we should keep in mind that such a cap will
   (a) force the hard trade-offs to be made within the budget process
   (b) serve also as a restraint to excessive taxation, and
   (c) by leading to lower interest rates, generate higher tax revenues for the Treasury through higher profit margins and a growing economy.

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PROPOSED JOINT RESOLUTION TO REDUCE TOTAL FEDERAL OUTLAYS AS A SHARE OF GROSS NATIONAL PRODUCT

a. The Congress hereby adopts the goal of maintaining Federal budget outlays at a level no greater than 20 percentum of the Nation's gross national product (defined as the final value of all goods and services in the economy).

b. The Congress, in furtherance of that goal, hereby establishes as its interim goals for reducing the share of the nation's gross national product accounted for by Federal outlays (expressed as a percentage of projected gross national product) as follows: 21.9% for fiscal year 1984, 21.4% for fiscal year 1985, 20.9% for fiscal year 1986, 20.4% for fiscal year 1987, and 19.9% for fiscal year 1988; and

c. Not later than May 15, 1983 the committee on the budget of each House shall report legislation to amend Public Law 93-344, the Congressional Budget Act of 1974, to require:

   1. that the budget resolutions for fiscal year 1984 and each subsequent years shall set forth percentage goals for total Federal outlays as a share of the projected gross national product for the current fiscal year and each of the four succeeding fiscal years,

   2. that the budget resolution for fiscal year 1984 shall incorporate the percentage goals specified in part (b) of this resolution, and

   3. that, for fiscal year 1985 and each subsequent year, the committee on the budget for each House shall report to its House a budget resolution which meets or falls below the percentage goal for total Federal outlays as a share of projected gross national product that was set forth for that fiscal year in the most recently adopted First Budget Resolution.

ANALYSIS OF THE PROPOSED JOINT RESOLUTION

a. This section represents a commitment by the Congress to reduce the share of GNP accounted for by Federal outlays to 20 percent or less. The 20 percent figure is taken from the Full Employment and Balanced Growth Act of 1978 as amended by Public Law 96-10. That amendment requires the President to set numerical goals for reducing the share of GNP accounted for by Federal outlays in his Economic Report.

b. This section represents the establishment of interim goals for the next five years by the Congress to reduce the share of GNP accounted for by Federal outlays. The 21.9% figure for FY 1984 is taken from the projections included in the First Concurrent Resolution on the Budget for FY 1983 adopted by the Congress. Subsequent reductions of 0.5% per year are specified for the next four fiscal years.

c. This section directs the budget committees of each house to report changes in the Budget Act by a date certain to incorporate

(1) a mechanism for establishing five-year numerical goals to reduce the share of GNP accounted for by Federal outlays in each budget resolution;

(2) to maintain in the first budget resolution for FY 1984 the interim numerical goals specified in this proposed joint resolution;

(3) a mechanism whereby the budget committee will report a budget resolution which meets or falls below the numerical goals set forth in the most recently adopted First Budget Resolution. The purpose of this is to assure that the numerical goals previously specified are a meaningful commitment by the Congress.

This section of the resolution purposely leaves the details of how the Budget Act is to be amended to accomplish the establishment of goals to reduce outlays as a share of GNP to the budget committees for two reasons. First, because of the complexities of the Budget Act itself. Second, because of the complexities that are certain to arise in establishing a mechanism for setting specific numerical goals in the budget process. It is recognized that some flexibility must be built into the process to handle such things as unexpected national emergencies such as war, sharp changes in interest rates, or sharp changes in economic conditions. It is left to the Budget Committees to decide what type of mechanism is needed to alter the numerical goals once they are established, for example, a two-thirds vote of each house. Also, the Budget Committees may want to establish a mechanism for flexible adherence to the goal of reducing the share of GNP accounted for by Federal outlays. For example, a base might be established and a trend line established that represent 0.5% reductions each year with the flexibility to permit overages or underages in a given year to be made up in the next year in order to keep the long-term goal on track.

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The **Chairman**. We will be happy to include them in the record.

CONTROLLING TOTAL NET CREDIT

In your statement you suggest that the Federal Reserve should target total net credit. Given that the Federal Reserve has no authority to set reserve requirements on such financial instruments as commercial paper and long-term corporate debt, how could the Federal Reserve control total net credit?

Mr. **Roberts**. I think the Federal Reserve today has a very big hand in controlling total net credit because the bank reserves that they do control set the level at which money growth will proceed and money growth, in turn, has an influence on the savings-investment process, and therefore, on the availability of funds to be borrowed and lent. Thus, I think to a very great extent they already do have an influence on total net credit.

To be sure, there may be additional powers that would be desirable to increase their influence on total net credit. At this point I am not prepared to recommend what those powers should be, but perhaps some additional powers are necessary.

Let me use Germany as an example. They control the money supply and they also control credit very tightly. To be sure the Bundesbank has additional powers of persuasion given the limited number of banks in Germany, than the Federal Reserve has. So in that sense the Federal Reserve does not have comparable powers of persuasion as the Bundesbank.

The **Chairman**. In your statement you say, "The Federal Reserve's ability to act flexibly and independently of day-to-day political pressures must be guarded and protected." You would certainly get no argument from Senator Proxmire and me over that. You listened to our speeches about the independence of the Fed for a long, long time.

Mr. **Roberts**. I think I wrote some of them.

Senator **Proxmire**. You sure did, mine.

The **Chairman**. Does that mean that you would oppose proposals to make the terms of the Fed Chairman and Vice Chairman coterminus with the President?

Mr. **Roberts**. I would not oppose making them closer to the terms of the President. I think exactly coterminus might prove to be a little bit difficult to deal with.

I think one proposal that was made several years ago was to have a 1-year lag between the appointment of the Fed Chairman and the election of a President. That I think would be livable and I see no problem with it.

The **Chairman**. You do not feel even that would, at least in a small way, threaten the independence of the Fed? You've got a Chairman that is a year hangover and you know that 1 year later the President is going to be able to pick his Chairman?

Mr. **Roberts**. I don't think that that would challenge the independence of the Fed any more than the powers that a sitting President now has to influence the Fed Chairman.

The **Chairman**. What about the proposal to make the Secretary of the Treasury a member of the Board of Governors?

Mr. **Roberts**. That I would have additional problems with. I think that that would politicize the process of monetary policy and I think it would be a dangerous precedent to set. I think one evidence of that is the fact that the Secretary of the Treasury was on the Board before 1933 I think and was then removed when the new powers of the Federal Open Market Committee were set up.

The **Chairman**. I'm certain you would oppose the proposals of some that would put the Fed under the control of the Treasury?

Mr. **Roberts**. I most certainly would.

The **Chairman**. I would have been terribly disappointed if you had said otherwise.

COMPARING M_1 AFTER 5 YEARS

In your statement you say, "The Federal Reserve should stop targeting M_1 because of NOW accounts and other financial innovations." Last week, Murray Weidenbaum, outgoing Chairman of the Council of Economic Advisers, described to this committee how the definition of M_1 has evolved over time to take account of such financial innovations. Chairman Weidenbaum concluded that as a result of this evolving definition of M_1 that growth of M_1 demonstrates the highest statistical correlation of the growth of nominal income.

How do you explain your apparent disagreement with Chairman Weidenbaum?

Mr. **Roberts**. If you look at M_1 now as compared to what M_1 was 5 years ago in terms of definition, I think there's a drastic difference. Five years ago before we had NOW accounts, before we had money market funds, before we had 6-month money market certificates, M_1 was a true measure of transaction deposits.

Now what we have in M_1 is a mixture of both transaction deposits and savings deposits and I think that savings deposits have a different relationship to GNP, employment and prices than transactions accounts. I think additionally, as the deregulation process proceeds, and the DIDC creates new instruments that have transaction-like characteristics, that you could have enormous shifts of funds out of what are savings accounts or what are money market funds or what are other similar instruments into M_1, and you would see an explosion in the M_1 measure that would have nothing to do with economic activity. I wouldn't know how to interpret that large increase in M_1 in any other way than that it has no relationship to past or prospective economic activity. It's merely a shift of funds, encouraged by a new instrument, that is not an increase in transaction accounts in the pure sense.

The **Chairman**. Steve, I had the opportunity to at least glance through your testimony and may I say on fiscal policy that I am very impressed with your recommendation. I think that the reexamination of the budget process is something that we've proven in the last 2 years absolutely needs to be done. It is not functioning well at all and we've put ourselves into the position of making some choices that have been very difficult.

I also agree very much with your recommendation about caps on Federal spending as a share of GNP. Senator Proxmire said earlier to Secretary Sprinkel, "What about the need to overcome this spending glut that has been going on?" We're so far higher than traditional spending levels of GNP and, in my opinion, that simply cannot be dismissed and say it's all monetary policy; we can just go on increasing the percentage of spending and have no repercussions on the economy. I think that's utterly ridiculous and it's overlooked constantly by Members of Congress and others.

Although I support the balanced budget amendment, we simply cannot go ahead and pass that during an election year, have it take a year or 2 to go through the States which I think it will, and then 2-year implementation after that, and not start controlling our spending now. You can't keep going on the way we're going and then suddenly there's an amendment that says you've got to do it and you've got to fall off a big cliff to accomplish it. So it seems to me your recommendation is absolutely on target that, fine, pass the constitutional amendment, but we've got to start disciplining ourselves in the meantime, and that means reducing that percentage of GNP that we are constantly appropriating year after year.

We're kidding ourselves; that constitutional amendment will become only a political document for an election year unless we start disciplining ourselves. So I'm very impressed with your testimony on fiscal policy.

Mr. ROBERTS. Let me say that I think the Congress could take a lesson from the rules that it has charged the Fed to follow; that is, to set annual targets, multiyear targets, and then discipline itself to meet those targets. And that's what the recommendation in my testimony is designed to do. But it's got to be like the Fed, a multiyear commitment for a gradual reduction in spending in a share of GNP.

If you'll recall, in 1979, Senator Proxmire and yourself were instrumental in getting the Full Employment and Balanced Growth Act amended to require the President to establish goals for reducing outlays per share of GNP. If it's good enough for the President, it ought to be good enough for the Congress.

The CHAIRMAN. It is, but you've also been around this body long enough to know that the hardest part of your recommendation is the part where you recommend that we discipline ourselves.

Senator Proxmire.

Senator PROXMIRE. Mr. Roberts, I want to congratulate you on what I think is an excellent statement. You've been around the committee long enough to know what serves the interest of the committee and what doesn't.

ADJUSTING PRIME RATES TO COST OF FUNDS

Your recommendations are concise and to the point and I think they're very timely. One of your first recommendations is that the Federal Reserve should immediately bring together senior representatives from the private sector to function like the Committee on Interest and Dividends, which was important during the early 1970's. That was the Nixon appointment at that time and as I understand it they adopted, you say on page 13, "One suggestion that was made and adopted by many banks was to have their prime rates set according to formulas linked to their cost of funds."

Is that the kind of recommendation that you would expect would be timely and appropriate now and would help to get interest rates under control?

Mr. **Roberts**. I think it would be very timely. I'm not sure what the spread should be. Conditions were different in the early 1970's than they are now. But if you look at current short-term rates, you have a prime rate of 15.5 or 16 percent; you have CD rates of about 11 percent, which is the cost of bank funds, and there's a huge discrepancy, much different than three-quarters or 1 percent. Draw your own conclusions.

The same point was made this morning with the announcement of the cut in the prime in a Washington Post article, that the spread between the cost of funds is now huge and that additional cuts in the prime rate should be forthcoming.

Senator **Proxmire**. Is that showing up in the increased profitability of banks?

Mr. **Roberts**. I think in general, rather than——

Senator **Proxmire**. I can't understand that. You know we have a very competitive banking system. The banks are very eager to lend money, as they showed in the Oklahoma case—sometimes a little too eager. But if the cost of funds is around 11 percent, this indicates a lack of effective competition, doesn't it?

Mr. **Roberts**. I think there is competition in the market. Bank profits are generally higher when interest rates are high, than when they are low. This is especially true now, as opposed to 10 years ago, because of the increased use of floating rate instruments and discrete pricing of banking services. I think that the banks will adjust downward, but there's a tendency for the prime to trail the market on the way down and to lead the market on the way up. I think that's a natural inclination. Anybody who wants to make a profit and maintain a spread would react rationally.

My suggestion is that now that the Fed, after October of 1979, has given the marketplace the ability to set rates and not to dictate to the marketplace what rates should be, and therefore, that participants in the marketplace have some responsibility for the well-being of the economy, not only their own well-being.

Senator **Proxmire**. Well, you say in your recommendations, "The Federal Reserve should bring together senior representatives of the private sector." Who would be the kind of people that would be appointed to that? The representatives, obviously, of the banks, savings and loans—what other—corporations?

Mr. **Roberts**. Financial and nonfinancial corporations, brokerage houses—anybody that has a major financial interest in the way the economy is moving ahead. I think it should be a broad group and I think it should have a broad mandate to look for innovative ways to get interest rates down.

Senator **Proxmire**. Well, that's very helpful.

Now, Secretary Sprinkel testified that there's no evidence that monetary policy is too tight. You say fiscal policy is too loose and monetary policy is too tight.

How do you answer Secretary Sprinkel's argument that monetary policy is about right?

Mr. **Roberts**. Secretary Sprinkel also said that he judges the inflation rate to be 5 or 6 percent, with the prime rate of 15.5 to 16 percent. That means a 10 percent real rate of interest, which I think is a signal that monetary policy is too tight. Look at bankruptcies. How do you judge bankruptcies? Is that an indication that monetary policy is too tight or too loose? There are lots of other things besides the rate of growth of the money supply, however you measure it, that the Fed needs to look at, and some of those variables are indicators.

PROBLEM CONTROLLING TARGET FOR M_1

Senator **Proxmire**. You seem to be coming on with the notion that you would increase the rate of growth in the money supply. Your only specific suggestion in here—you didn't say that in your testimony. You said that you would drop M_1 and develop a total net credit and rely on the recommendations of these experts that would be appointed to some extent. But should we ease up on the rate of increase in the rate of credit and money supply? That's the real fundamental question.

Mr. **Roberts**. I think there should be some easing, yes. I don't think the targets should be changed, but I agree entirely with Chairman Volcker that if for a period of time money growth is above target that in this current economic environment there should be little problem. We have so much excess capacity that it would not be inflationary.

Senator **Proxmire**. Money growth is above target. Why shouldn't we change the targets under those circumstances? Why shouldn't we increase the targets?

Mr. **Roberts**. Well, first of all, I think the target for M_1 ought to be dropped. I said that in my testimony. Therefore, I see no reason for changing it. If you want to make a change, drop it.

Senator **Proxmire**. Drop the ranges that we've asked the Federal Reserve to tell us about?

Mr. **Roberts**. For M_1.

Senator **Proxmire**. For M_1?

Mr. **Roberts**. And maintain them for M_2 and M_3.

Senator **Proxmire**. I see. Now I just had one other question I think.

Secretary Sprinkel said that it was impractical to expect the Federal Reserve to control the total net credit. You've answered this in part in response to the Chairman, but I'd like to get a more specific answer.

He said we have trouble controlling M_1, which we do; M_1 is easier to control than the total net credit. You have indicated that there are some areas of total net credit—I guess Sprinkel did—outside the purview of the Federal Reserve. Are you suggesting that we broaden their power over commercial paper, for example, and some of the other credit aggregates they don't have any control over?

Mr. **Roberts**. I think that's something to be explored. I wouldn't say, yes, they should have increased control over commercial paper or anything else at this point. But as I look at the historical evidence presented by Professor Friedman from Harvard and several other economists who have looked at these things very carefully, there's a steady and persistent relationship between net total credit adjusted for the rate of growth of the economy. It's about 143 percent adjusted for the way the economy changes.

The Fed has some influence to change that by supplying additional reserves if need be, especially if total net credit is lagging sorely behind what historical evidence suggests it should be.

I look at the evidence and I'm convinced—and I wasn't convinced when I was on the committee staff several years ago—but I am convinced now based on this new research that the Fed ought to pay attention to total net credit, that bank credit is just one part of it but it's not the entirety, and you learn something from total net credit. You learn right now that the Federal Government is going to take almost 50 percent of the share of all credit generated if you include off-budget and on-budget items in the next year. That means that the private sector is going to be crowded out. There's important information there.

Senator PROXMIRE. You can make an argument on that, but my question is whether or not they can actually control it?

Mr. ROBERTS. They can control it just as well as they can control M_2 or M_3. Reserves are no longer set on savings and consumer time deposits of any type, but changes in reserve availability influences their growth indirectly.

Senator PROXMIRE. I also get from your argument and your presentation this morning that maybe the decision in October 1979 was wrong; forget about interest rates and concentrate on the rate of increase in the money supply. I say that because there is this colossal spread. Interest rates seem to be way out of tote with what they ought to be in view of the cost of funds. So why shouldn't there be some return perhaps to an attempt on the part of the Federal Reserve to bring interest rates down as such, rather than simply the money supply?

Mr. ROBERTS. As you know, in October 1979 I supported that change in policy because I thought it was important to focus in on the rate of growth of money. However, I think that conditions have changed. M_1 doesn't mean the same thing now as it did in 1979, as Mr. Maude's testimony of last week clearly shows. NOW accounts weren't here in 1979. I think, also, that tight adherence to the rate of growth of the money supply week to week, month to month, quarter to quarter even, has proven to be quite hard to follow. That's why the Full Employment Act requires that the Fed target the rate of growth of money over a year's time and I think that the tight adherence to monetarism can in certain circumstances—and I think we're in those circumstances right now—be fairly dangerous. Therefore, at this point, I think the Fed ought to look at other variables.

Senator PROXMIRE. Including interest rates?

Mr. ROBERTS. Including interest rates, including real interest rates especially.

Senator PROXMIRE. Thank you.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Mr. Roberts, we're happy to have you before us today. I have no additional questions. Senator Proxmire, do you have any more?

Senator PROXMIRE. It was a very good statement.

The **Chairman**. Very good. Thank you very much. We appreciate you returning to the site of your previous activities.

Mr. **Roberts**. Thank you.

The **Chairman**. The committee is adjourned.

[Whereupon, at 10:45 a.m., the hearing was adjourned.]

[Additional material received for the record follows:]

Answers to Additional Questions For Steven M. Roberts
From Senator Donald W. Riegle

Q.1. Whom would you appoint and what exactly would be the mandate and time frame of your proposed Committee to get interest rates down?

A. As I indicated in my testimony the private sector has a responsibility for acting in the national interest in setting terms and conditions on credit because of the Fed's October 1979 shift toward controlling money and reserves and letting the marketplace set interest rates. Prior to October 1979 the FED set interest rates and the marketplace would often have to allocate credit in non-price terms. Some type of allocation system, perhaps, should be restored.

What I have in mind is a public-private group to generate innovative ideas to reduce interest rates and then to obtain broad support from the private sector to put those ideas into action.

Committee membership might include:

Public Sector

Secretary of Treasury
Chairman of the Federal Reserve Board
Chairman of the Council of Economic Advisors

Private Sector

Representatives of large, medium, and small banks
Representatives of non-bank financial institutions
Representatives of major manufacturing corporations and small business

I would also recommend that Arthur F. Burns, now Ambassador to the Republic of Germany and a former Chairman of the CID, and Secretary Schultz, a former member of the CID, be asked to participate. Also, former FED Chairmen Martin and Miller, and former Treasury Secretaries Dillon, Fowler, Simon, Connolly, and Blumenthal could contribute needed ideas and support.

One group of bankers that might be asked to serve on such a committee would be the Federal Reserve's Federal Advisory Council which is made up of twelve bankers, one from each Federal Reserve District, and already advises the Board regularly. Other bankers might also be included to broaden the base.

People like Peter G. Peterson of Lehman Brothers, Jim Robinson of American Express Company, the Chairman of Ford Motors, the Chairman of General Electric, and other prominent business leaders would also add to the collective wisdom of the body.

The mandate should be to find several complementary ways to get interest rates down without fueling inflation. This may mean some non-price rationing of credit and some self restraint by borrowers.

The time frame for formulating approaches to the problem should be short -- within the next 30-45 days. The Committee should function for a year or less as needed.

Let me stress that the initiative has to be voluntary, but with broad compliance based on a consensus that steps are necessary and the burdens need to be shared more broadly than they are currently.

Q.2. You recommend in your testimony that the "FOMC should immediately adopt a 'total net credit' aggregate as an additional target for policy". What do you mean by a "total net credit" aggregate?

A. "Total net credit" is a term used by Professor Friedman at Harvard. It includes the outstanding indebtedness of all U.S. non-financial borrowers. He suggests that this indebtedness be scaled to economic activity. At year-end 1981 outstanding indebtedness of all U.S. non-financial borrowers was 143% of gross national product.

Q.3. How would the FED accumulate the data and measure the total net credit?

A. The Federal Reserve publishes data on total net credit in its quarterly flow of funds accounts. As of year-end 1980, total net credit was $3,907.5 billion. Much of the underlying data are available and reported regularly each month. According to Friedman, $3,486.6 billion or 89% of the total year-end 1980 data was available from monthly series. Much of the monthly data that were not available was federal government borrowing. The government could improve its own reporting system to bring the monthly data availability close to 100% of that available quarterly.

Q.4. How would the FED establish a target for total net credit and how would the FED adjust monetary policy to achieve such a target?

A. Total net credit adjusted (or scaled) for GNP growth has been fairly steady at 142-143%, except during the 1930's depression and just after WWII. If 143% of GNP is taken as the long-term stable trend, then the FED's target would be calculated from its forecast for GNP for the year multiplied by 143%.

If, during a recession, GNP grew more slowly than predicted, the scaled net total credit aggregate would rise above 143% because the denominator would grow more slowly than the numerator. To get the aggregate back down to 143% the FED would adjust policy to improve GNP. This is an over-simplification, of course. In essence, more money or lower interest rates would tend to increase GNP.

Q.5. How would targeting of total net credit assist in achieving monetary policy objectives such as economics growth, price stability, employment and international balance? What is the relationship between total net credit and these objectives?

A. Using total net credit as an additional target variable would provide additional important information as to economic activity and what monetary policy should be doing to achieve its ultimate objectives for income, employment, etc. To continue the example from the previous question, an acceleration of total net credit might serve as an early indication of weakness in GNP, as additional credit is needed to finance economic activity. The opposite might also be true: a deceleration might indicate strength in internal cash flow, profits and output.

I suggest that Professor Friedman's work on this be sought by the Committee to answer the last part of this question.

Q.6. What economic signals would be contained in various movements and fluctuations of total net credit?

A. See answer to Question 5.

Q.7. How would the Federal Reserve System exercise very precise control over the total net credit aggregate in the short run?

A. It would not and should not exercise precise control of total net credit or any other intermediate target variable over short-time horizons! Monetary policy objectives can only be attained over longer time periods (a year or two) because of the lags between policy changes and changes in intermediate or final targets.

Changes in economic variables over short-time horizons can be and often are misleading. It is long-term trends that are important.

Q.8. What, if any, new powers would the FED need to adequately implement or credit aggregate (target) such as you have suggested?

A. No additional powers are necessary. However, it might be desirable to give the Fed some additional authority to provide incentives to lenders to increase lending in certain areas -- such as agriculture, autos, small businesses. But such powers would need to be considered carefully. Experiences of other central banks should be looked at. I can mention two variables that have been looked at in the past -- loan to deposit ratios, and capital-asset ratios. The current system might be improved if the FED had greater control over these variables.

The Trouble with Monetarism

ALAN REYNOLDS

In the entire history of this country, before 1968, long-term interest rates were never above 5-6 percent. Since then, however, interest rates have tripled. Young people now think it is perfectly normal that mortgage rates can only go up—as they have in every single year since 1972.

Something terrible happened to the economy after 1968, got even worse after 1972, and deteriorated into acute stagnation after 1979. There has been virtually no increase in real output per employee for nearly a decade. World trade grew by 7 percent a year for twenty-five years before 1973, but that growth was cut in half since then (actually falling one percent last year).

It is time to retrace our steps, to find out what went wrong.

Advice from the familiar economic experts will not be better than it has been. A Keynesian adviser to J.F.K. now argues that budget deficits force the Federal Reserve to print *less* money; a founder of the rational expectations school says deficits force the Fed to print *more*. The head of a huge forecasting empire, built upon the idea that deficits stimulate investment, now casually argues the exact opposite. The monetarist economist for a New York investment bank says the Fed is doing such a great job, that inflation and interest rates must be due to fiscal policy after all. An Ivy League professor, who has always argued that any inflation was a trivial price to pay for the low unemployment that would surely result, is now solemnly interviewed about what to do about inflation. The fiscal expert at a conservative think tank says deficits will be inflationary unless inflation shrinks them. A prominent monetarist who has always emphasized long-run trends in M2 now worries only about ten-week wiggles in M1.

To uncover the source of change, it is useful to look at what has stayed the same. Federal tax revenues rose by 15.8 percent in 1981—far more than the incomes of taxpayers. Marginal tax rates are still going up, not down.[1] Does anyone really believe that the economy would have performed better if the tax collector had grabbed an even larger share? Nondefense spending will be at least 17.4 percent of GNP in fiscal 1982, up from 15.9 percent in 1979. Would anyone seriously argue that recession could have been avoided if the O.M.B. had only let federal spending drift even higher?

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[1] Stephen A. Meyer & Robert J. Rossana, "Did The Tax Cut Really Cut Taxes?" Federal Reserve Bank of Philadelphia *Business Review* (January-February 1982).

No, this problem is monetary, not fiscal. For all practical purposes, "Reaganomics" means whatever the Federal Reserve is doing. If interest rates were remotely close to historical normality (namely, 3–5 percent), the budget would be in surplus. In fact, there is substantial evidence that expected inflation causes budget deficits rather than the other way around.[2]

Criticism from Wall Street

The media would have us believe that "Wall Street" is not concerned about monetary policy, but only about deficits. Polls of dozens of institutional investors by Oppenheimer and Polyconomics, however, indicate that this is overwhelmingly untrue. *Fortune's* poll of executives says the same.

Barton Biggs, the managing director of Morgan Stanley, recently described monetarism as "the God that failed." He reprinted a letter of February 22 from Peter Vermilye, Chief Investment Officer at Citibank, saying "the level of interest rates is a better barometer of tightness than the growth of the money supply in this era of conflicting monetary currents." The economists at Morgan Stanley and Citibank are staunchly monetarist, but those responsible for investments are not.

Many other Wall Street traders and economists have long been extremely critical of monetarism, including Henry Kaufman of Salomon Brothers, George McKinney of Irving Trust, Peter Canelo of Merrill Lynch, and Edward Yardeni of E. F. Hutton. The widely-read *Morgan Guaranty Survey* (of February 1981) wrote that the nation "would be ill-served by rigid mechanical monetarism."

"The widely-cited budget deficit problem," says Maury Harris of Paine Weber, "is due importantly to Federal Reserve policies that keep interest rates high." "Until such time as the Fed abandons monetarism," says David Levine of Sanford Bernstein, "our financial markets will be in disarray."[3] These are not uncommon views on Wall Street, though the media decided that this news is not fit to print. Instead, we hear the same tired voices agonizing over the budgetary consequences of monetary disorder.

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[2] Brian Horrigan and Avis Protopapadakis, "Federal Deficits: A Faulty Gauge..." Federal Reserve Bank of Philadelphia *Business Review* (March-April 1982). Also unpublished studies by Gerald Dwyer at Emory and Roger Kormendi, University of Chicago.

This is not the first time that the United States has contemplated a fiscal cure for a monetary crisis. The huge tax increases of 1932 and 1968 demonstrated that it does not work.

Today's monetary crisis is not new, but it has escalated into risky territory. The entire dollar economy worldwide is dangerously illiquid, precariously dependent on short-term debt. Long-term financial markets are moribund. People, and the institutions entrusted with their savings, are unwilling to commit funds for long-term uses. Nobody trusts the money. Interest rates are held up by the rising risk of default right now, and by the risk of renewed inflation in the future.

We have the worst of two worlds: Much of the nation is *experiencing* deflation while *expecting* an inflationary "solution." By April 1982, most indexes of commodity prices were at least 15-20 percent lower than a year before. Cotton was down about 25 percent—the same as in 1932—aluminum prices were down even more. Even the broad indexes of producer and consumer prices had posted some monthly declines. Even as the old guard was chanting that budget deficits cause inflation, inflation again went way down as the deficit went up—just as in 1975, or 1933.

Yet even *falling* prices fail to persuade bond buyers that they will not be exploited once again by future inflation. Indeed, the more that current price indexes are squeezed by forcing producers into bankruptcy, the more likely an inflationary bail-out becomes. Existing monetary techniques can thus depress measured inflation for even a year to two without making a serious dent in expected inflation. Trouble in long-term markets requires a *long-term solution*, a credible set of monetary institutions to protect the purchasing power of the dollar.

Selling what exists at falling prices does not necessarily make it easier to produce more at stable prices. Liquidation of inventories, commodities, assets, and real estate has depressed current price indexes, but it has also *raised* the cost of living *in the future*. The value of lifetime savings has fallen, so people will have to work harder in the future to attain any expected standard of living. That makes the future look relatively grim, causing people to prefer present consumption. In this situation, providing added tax incentives to save will not finance future productive capacity, because any added savings remain in the short-term money market.

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[3] Dr. Harris' remark is from testimony before the Joint Economic Committee, April 22, 1982; David Levine's is from a speech to the New York Association of Business Economists, April 6, 1982.

The problem is that the United States has no long-term monetary policy at all—nothing that inspires confidence. Instead, the nation alternates between robbing lenders with inflation and bankrupting borrowers with deflation. There is no way of knowing which is coming next, so activities requiring long-term financial contracts are severely restricted. There is no unit of account that is expected to hold its value over decades, and therefore little possibility of building for the future by borrowing against expected future earnings.

No indexing scheme gets around the problem of unpredictable money. A household cannot budget for the future, for example, if monthly mortgage payments can vary in ways that income may not.

Monetarism was fun when it simply involved second-guessing the Fed. The self-appointed "Shadow Open Market Committee" would solemnly announce that there was too much or too little money, without assuming any genuine responsibility.

Things are different now that prominent monetarists are in positions of great authority. Monetarists can and do influence the Fed now, and are even in a position to propose sweeping monetary reform, legislation, or international conferences. Instead, we still get the habitual second-guessing. The Republican section of the latest *Joint Economic Report*, for example, writes: "Looking back, it would have been better if money had grown closer to 5 or even 6 percent per year in the second and third quarters of 1981 instead of at annual rates of 3.6 and 2.9 percent." Such retroactive fine-tuning serves no useful purpose. The bond and mortgage markets did not collapse over the past decade because money growth was one or two percentage points too slow for six months.

Founders of Monetarism

It can, of course, be argued that what we are experiencing is not genuine monetarism. When reality fails to live up to the promise of theory, it is always the fault of reality. Since October 1979, when the Fed did most of what the monetarists advised, interest rates, M1 and the economy have gyrated wildly. The monetarist response is that the problem originated with lagged reserve requirements in 1968, or the Fed should have stepped even harder and faster on monthly ups and downs of M1 (for example, by pushing the fed funds rate higher in January 1982, when M1 surged).

Is there *any* example of monetarism anywhere that ever worked? Some point to Switzerland, where M1 rose 23 percent in 1978, fell 7 percent last year, and has been far more erratic over short periods than in the U.S. Switzerland has a gold cover on its currency. Others point to Chile, where they stopped hyperinflation by using fixed exchange rates. France tried a quantity rule from 1919 to 1925, but it blew up with a 50 percent inflation rate.

But the fault runs deeper than the Utopian nature of monetarism. The fault lies in the deliberate demolition of *proven* monetary institutions (of the sort now used in Switzerland and Chile) for the sake of a *hypothetical* quantity rule that has never been put into practice.

This requires a brief digression into the development of monetarist policy proposals. The early "Chicago School" of economics, around 1927–41, may have been more favorably inclined toward free markets than Harvard, but not much. Like most academics, the early Chicagoans were intimidated by the intellectual consensus of the day. It was thus conceded that industrial and labor markets were largely monopolized and rigid, so the influential Chicagoite Henry Simons redefined "laissez-faire" as strict legal limits on the size of corporations and the power of unions.

To Simons, the "utter inadequacy of the old gold standard... seems beyond intelligent dispute." The experts would simply "design and establish with greatest intelligence" a "definite mechanical set of rules" for money. Simons' modest proposal involved "above all, the abolition of banking, that is, of all special institutional arrangements for financing at short-term....If such reforms seem fantastic, it may be pointed out that, in practice, they would require merely drastic limitation upon the powers of corporations (which is eminently desirable on other, and equally important, grounds as well)."[4]

The idea of a fixed rate of growth of the money supply originated in 1927 with the even more interventionist left wing of the "Chicago School," namely Paul Douglas. Douglas (later a Senator) was then quite excited about a "planned economy" and "public ownership," and even called himself a socialist.[5]

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[4] Henry C. Simons, "Rules Versus Authorities in Monetary Policy" (1936) in *Landmarks in Political Economy* (University of Chicago, 1962).

"The obvious weakness of fixed quantity," responded Simons, "as a sole rule of monetary policy, lies in the danger of sharp changes on the velocity side." Moreover, "the abundance of what we may call 'near moneys,' " Simons wisely added, creates a "difficulty of defining money in such manner as to give practical significance to the conception of quantity." Just as Simons' solution to big business was to make it illegal, his solution to free financial markets was to make them illegal too. Then a quantity rule might work.

By 1948, Keynes had infected even Chicago, as shown by Milton Friedman's "Monetary and Fiscal Framework for Economic Stability." That proposal was to run budget deficits in recessions and "the monetary authority would have to adopt the rule that the quantity of money should be increased only when the government has a deficit, and then by the amount of the deficit." The budget could be balanced over the cycle, or lead to "a deficit sufficient to provide some specified secular increase in the quantity of money."

Some might worry, said Professor Friedman, that "explicit control of the quantity of money by government and explicit creation of money to meet actual government deficits may establish a climate favorable to irresponsible government action and to inflation." "This danger," he added, "can probably be avoided only by moving in a completely different direction, namely, toward an entirely metallic currency, elimination of any governmental control of the quantity of money, and the re-enthronement of the principle of a balanced budget."[6] By implication, that was still beyond "intelligent dispute." Needless to say, the nation did not move in the latter direction, nor did Professor Friedman ever really advise it to do so.

By 1962, in his magnificent *Capitalism and Freedom*, budget deficits no longer worked to stabilize demand. The task had become one of steering between the Scylla of a gold standard and the Charybdis of wide discretionary powers. Professor Friedman initiated the caricature of an "honest-to-goodness gold standard, in which 100 percent of the money consisted literally of gold." Since that sort of standard is indeed ridiculous, Professor Friedman instead suggested raising M2 by 3-5 percent every year. With practice, however, "we might be able to devise still better rules, which would achieve even better results."[7] This was a return to Paul Douglas, neglecting the doubts of Henry Simons and Frank Knight.

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[5] J. Ascheim & G. S. Tavlas, "On Monetarism and Ideology" Banca Nazionale del Lavoro *Review* (1979).

[6] Milton Friedman, *Essays in Positive Economics* (University of Chicago, 1953) pp. 133–5.

On January 1, 1968, Milton Friedman wrote "We should at once stop pegging the price of gold. We should today as we should have yesterday and a year ago and ten years ago and in 1934—announce that the U.S. will no longer buy or sell gold at any fixed price. . . . That would have no adverse economic effects—domestically or internationally."[8] The advice was taken that March.

Professor Friedman later acknowledged "direct links" between his views and those of Jacob Viner, quoting Viner as saying, "if the mere cessation of gold payments did not suffice to lower substantially the international purchasing power of the dollar I would recommend its accompaniment by increased government expenditures financed by the printing press."[9]

When the term "monetarism" was coined by Karl Brunner in 1968, it represented a healthy backlash against the excesses of fiscal fine tuning. Yet monetarism too was part of the Keynesian tradition of demand management. The tools would be different, but the objective was still to manage the rate of growth of aggregate demand, whether over short or longer periods of time.

Early monetarists were often quite activist demand-siders. John Culbertson, in 1964, argued that the U.S. should "give up our self-imposed constraints" and "make an end of monetary restriction." By breaking all links with gold, he said, we could safely pursue a "moderately expansive" policy of increasing the money supply "something like 6 to 8 percent." As unemployment came down to 4 percent, we might then print a bit less.[10]

Some monetarists still cannot resist offering advice for fine-tuning the growth of money to achieve some cyclical smoothing. Robert Hall (who joined me as a member of President Reagan's inflation task force before the election) wanted to increase the money supply at a 20 percent rate for at least six months in late 1976.[11]

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[7] Milton Friedman, *Capitalism and Freedom* (University of Chicago, 1962) Ch. 3.

[8] Milton Friedman, *An Economist's Protest* (Thos. Morton, 1972) pp. 98-99.

[9] R. J. Gordon (ed.), *Milton Friedman's Monetary Framework* (University of Chicago 1970) p. 167.

[10] John M. Culbertson, *Full Employment or Stagnation?* (McGraw Hill 1964) pp. 234-235.

"The year 1973," notes Robert Gordon, "represented the high-water mark of monetarism."[12] By then, all of the old-fashioned obstacles to scientific demand management had been toppled. The U.S. took the silver out of coins in 1964, lifted the gold cover on Federal Reserve notes in 1965, set the gold price free in March 1968, reneged on converting foreign dollars into gold on August 15, 1971, and embraced floating exchange rates by March 1973.

The monetarists cheered. They had provided the intellectual rationale for the demolition of all institutional constraints on monetary policy. There was a promise to replace the old rules with new rules, but it has not happened. What happened is that rules were replaced by random whim.

Henry Simons was right in 1936 to prefer rules to discretion, but wrong to propose an alternative that could only work if flows of money and credit could somehow be tightly regulated.

"The defects of monetarism," writes Samuel Brittain, "are that it concedes too much power to official intervention, underrates the influence of competition in providing money substitutes, and takes official statistics far too much at their face value. Friedmanites are often very good at analyzing how controls and regulations in the economy generally will be avoided or will produce unintended effects quite different from those their sponsors desire. But too often they evince a touching faith in government in their own special sphere."[13]

Meaningless Money

Monetarism is properly a method of analysis or prediction, not a policy. No particular policy necessarily follows from a monetarist view of the world. Monetarists have favored a wide variety of policies, including some sort of commodity standard.

The meteoric rise of monetarism had much to do with its simplicity, and to the persuasive talents and personal charm of its major salesmen. Monetarism begins with a seductive tautology: The rate of growth of spending or "demand" (nominal GNP) depends on the rate of growth of money (M) plus velocity (V). Converting the old quantity equation into annual percentage increases, then $M + V = GNP$.

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[11] *Business Week* (November 15, 1976) p. 26.

[12] Robert J. Gordon, "Postwar Macroeconomics" in Martin Feldstein (ed.), *The American Economy in Transition* (University of Chicago 1980) p. 146.

[13] Samuel Brittain *How to End the Monetarist Controversy* (Institute for Economic Affairs 1981) p. 84.

If we could count and control M, and if we could predict velocity, then we would reach the Keynesian heaven of managing "aggregate demand." And if we could also predict how much of that rise in GNP would be real growth and how much would be inflation, then we could use all this to "control" inflation. The only trouble is that nobody can do *any* of those things. Even if anyone could, there is no reason to suppose that these devices would actually be used to avoid inflation or deflation.

Basically, the goal of managed money is to control $3 trillion in annual spending through periodic adjustments in about $45 billion of bank reserves. Not an easy task.

First of all, what is money? In March 1979, the Shadow Open Market Committee noticed that "there is now a large and rapidly growing volume of financial assets not subject to ceiling rates on deposits...and in some cases not subject to reserve requirements." By February 12, 1982, one member of the Shadow Committee, Erich Heinemann of Morgan Stanley, was showing more concern:

> The improvements in the monetary definitions are unfortunately minor in comparison with the more fundamental conceptual problems associated with measuring money. To what extent are household money market mutual fund shares transaction or savings balances? Are institutional holdings of overnight RPs or overnight Eurodollars transaction balances since they are available each morning for spending? Are institutional holdings of marketable and highly liquid short-term credit instruments such as Treasury bills, certificates of deposit, and banker's acceptances so easily convertible into transaction balances that they should be so treated? If we exclude them from transaction measures, such as M-1, are we missing a large and important source of corporate liquidity? Anyway should holdings of Treasury bills, which are more liquid than CDs, be included in L, while CDs are included in M-3? The questions go on and on, and few of them can be answered unambiguously. The questions linger, and the quality of virtually any definition of money remains uncertain. In this context, the redefinitions are minor refinements in *the hopelessly difficult task of measuring money*.

These sorts of doubts have often marked the beginning of the end of confidence that controlling some arbitrary measure of money is a practical way to ensure its value. At the end of 1975, I wrote a paper for Argus Research on "The Increasing Irrelevance of M1." In 1979, when some prominent monetarists were saying that money growth was too slow, I wrote (with Jeffrey Leeds) that failure to count money market funds and repurchase agreements was understating the six-month rate of money growth by more than seven percentage points.[14]

Peter Canelo, a top bond analyst at Merrill Lynch, likewise became disillusioned about monetarism through his enormously detailed weekly reports on what the various M's really mean. Lately, Phillip Cagan of Columbia, one of Professor Friedman's first and best proteges, has expressed similar doubts.[15]

On October 6, 1979, the Fed essentially announced that it would let interest rates approach infinity, if necessary, to slow the growth of bank reserves and M1. The C. J. Lawrence survey of bond managers' forecasts for long-term government bond yields went from 9 percent on September 14, 1979, to 12.3 percent in five months.

Now, there is no question that high interest rates can drive money out of M1 and bank reserves, but that also raises velocity. At high interest rates there is a powerful incentive to keep as little money as possible in M1 deposits, which pay little or no interest. Banks have an equally powerful incentive to use "liability management" to make the most loans with the least required reserves, since reserves at the Fed earn no interest.[16]

Money market funds have been more than doubling in size each year and, at about $160 billion, are much larger than the entire stock of currency. You can write checks on most of these funds, or transfer to a checking account with a phone call. Overnight repurchase agreements and Eurodollars usually exceed $40 billion, and are curiously lumped together with 8-year certificates in M2. Such cash management devices have only been significant for two or three years, making the old historical relationships (such as postwar velocity "trends") quite suspect.[17]

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[14] "Understating Monetary Growth," *First Chicago World Report* (March-April 1979).

[15] See James Grant's column, *Barron's* July 27, 1981, and Sanford Roie's column, *American Banker* (Nov. 24, 1981).

[16] James Earley & Gary Evans, "The Problem Is Bank Liability Management," *Challenge* (January-February 1982).

[17] M. Dotsey, et al., "Money Market Mutual Funds and Monetary Control," Federal Reserve Bank of New York *Quarterly Review* (Winter 1981-82).

MasterCard plans to offer a "sweep account" for small depositors, where check balances are kept within a desired range, and any excess or shortage is moved around from money market funds or other near-monies. If the Fed counts demand deposits at the wrong time of the day, they might not find much. There are other devices on the horizon such as CDs with check-writing privileges, checks on Visa cards, and retail repurchase agreements. The whole idea of measuring M is growing more obsolete by the day.

The Fed makes the rules of the monetarist game, because the Fed defines the M's. The definition has changed four times since late 1978. How could any long-term rule be formulated in terms of a quantity of money when the definition of money is necessarily subject to continuous change?

Money numbers are also constantly revised. In early 1982, we finally learned that a 5.4 percent rate of decline in M1 in the previous May was really a 10.8 percent rate of decline; a 14.5 percent increase in November turned out to be 10.1 percent. How could the Fed possibly stabilize M1 before anyone knows how much it rose or fell?

High interest rates drive money out of M1 into interest-earning, highly-liquid devices that have little or no reserve requirements. So neither M1 nor reserve aggregates (the base) have the same meaning as they did when interest rates were much lower. Most of the financial innovations are roughly counted in M2 or M3, but those measures also contain much larger amounts of longer-term savings.

A fall in interest rates might well induce people to keep more of their income in M1, but that shift from M2 into M1 would *not* be inflationary. An increase in real output would raise the need for cash to finance more transactions, but supplying that demand would *not* be inflationary. A rise in the savings rate would probably increase M2, but that too would *not* be inflationary. It depends on real growth and velocity.

In the fourth quarter of 1981, the interest rate on 3-month T-bills fell from 15 percent to 11.8 percent. The growth rate of M3, which is dominated by interest-sensitive instruments, slowed from 11.2 to 9.2 percent. The growth of M1, which is discouraged by high rates, rose from zero to 5.7 percent. The monetary base slowed down. What does all this mean? Not much.

Monetarists still can't decide on a meaningful and controllable measure of money. Phillip Cagan of Columbia and David Laidler of Western Ontario strongly favor M2. The St. Louis Fed and

Robert Weintraub of the Joint Economic Committee are sticking with M1. Allan Meltzer of Carnegie-Mellon seems to be leaning toward the monetary base. Milton Friedman used M2 last year to show that money growth had not slowed down, but uses M1 this year to show that money growth has not been steady.

It makes a lot of difference. It should be obvious that high interest rates artificially depress M1 and raise its velocity, that the monetary base shows almost no predictable relationship to anything in the past two years, and that broader aggregates are not controllable by the Fed.[18] Besides, the broader aggregates have been speeding-up in the last yar or two, so the traditional Friedmanite long lag with M2 supposedly points to more inflation ahead while M1 or the base does not. (M2 rose 10 percent in 1981; M3, by 11.4 percent.)

Not all of the confusion, however, suggests that money is undercounted. Most of the monetary base and a big chunk of M1 is simply currency. David Whitehead of the Atlanta Fed estimates that most of the big bills (and 69 percent of all currency) are hoarded.[19]

In a period of great financial uncertainty and insolvency, the prospect of a major surge in the demand for currency should not be ruled out, despite the lost interest. In this case, the monetary base would be particularly misleading, as it was throughout the Great Depression. A lot of "currency in circulation" would not really be in circulation.

Volatile Velocity

Monetarists have a double standard when it comes to judging the stability of the money supply or velocity. Comparing percentage changes between fourth quarters, velocity fell in 1967 and 1970, yet rose by 5-6 percent in 1965, 1966, 1973, 1975 and 1978. Robert Weintraub complains that this is "selective and myopic... terribly short-sighted and gives very misleading signals."[20] He insists that velocity data should be smoothed by comparing averages over the whole year with the year before, or better still, by comparing three-year averages.

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[18] Nancy Kimelman, "Using Monetary Targets as Intermediate Targets: Easier in Theory Than in Practice," Federal Reserve Bank of Dallas *Voice* (December 1981). Patrick Lawler "The Large Monetary Aggregates as Intermediate Policy Targets," Federal Reserve Bank of Dallas *Voice* (November 1981).

[19] "Money Supply Gauge May Be Inaccurate," *Washington Report* (April 20, 1982).

[20] Maxwell Newton published the exchange in *New York Post* January 15, 1982.

When it comes to the money supply, however, monetarists certainly do not mind comparing changes between fourth quarters (this is the way Fed targets are set), or even changes between 8–10 week periods converted into compound annual rates of change.[21]

If quarterly changes in velocity are likewise expressed as an annual rate of change, as Professor Friedman does for even shorter periods with M1, then velocity swings *far* more wildly than money —up 13.2 percent in the first quarter of 1981, down 4.5 percent in the second, up 9.5 percent in the third, down 1.2 percent in the fourth, and down 10.5 percent in the first quarter of 1982. Monetarists are able to contrast the "stability" of velocity with the instability of M1 only by hiding the numbers.

Velocity was relatively predictable in the stable world of Bretton Woods, but all models to predict velocity broke down after 1972–73, when the U.S. suspended gold convertibility and endorsed floating exchange rates. Interest rates now move as much in a day as they used to in a year. Thus, a survey on the demand for money by David Laidler laments that "it was never possible completely to get away from the conclusion that the function has shifted after 1972." "After all," Professor Laidler notes, "monetary policy is implemented over time, and unless the relationship it seeks to exploit can be relied upon to remain stable over time it cannot be used successfully."[22]

At the end of 1980, a rigorous study by Robert Weintraub said, "We expect the trend rate of rise of M1B's velocity to drop from 3.2 to about 2% per year, with the spread of NOW accounts. We would compensate for this by adjusting the long run target for yearly M1B growth upward by 1 to 1½%."[23]

Velocity is officially classified as a coincident cyclical indicator, so it fell with the sharp fall in real output from last October through March. The only half-hearted expansion the U.S. has experienced lately was between the third quarters of 1980 and 1981. At that time, velocity of both M1 and the base did not rise by 2 percent, or by 3.2 percent, but by *6* percent. Is this the new "trend" for velocity if and when the economy recovers? Nobody has the slightest idea.

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[21] Milton Friedman, "Monetary Instability," *Newsweek* (December 21, 1981).

[22] David Laidler, "The Demand and Supply of Money Yet Again," paper presented to a Carnegie-Rochester conference, April 1979. See also Albert Friedberg, "Gold and Demand-Side Monetarism," *Bondweek* (November 9, 1981).

[23] House Subcommittee on Monetary Policy, *The Impact of the Federal Reserve System's Monetary Policies on the Nation's Economy* (U.S. Government 1980) p. 43. In this model (p. 33) "it takes two to four years for changes in money growth to change the rate of inflation," so the slowdown in inflation in 1981 must have been due to slower money growth around 1977–79?

Whatever "stability" can be found in long-run trend of M1 velocity is only because M1 has been redefined. The old M1 velocity showed an even clearer tendency to accelerate during each cyclical expansion, averaging 3.1 percent from 1961-69, 3.5 percent from 1970-73, and 4.9 percent from 1975-79. And the gyrations were becoming larger.

The unpredictability of velocity became even worse after the October 1979 emphasis on the M's. "Erratic velocity behavior of the traditional monetary aggregates led the Federal Reserve to redefine the aggregates. However, the new monetary aggregates have also exhibited erratic velocity behavior....Paradoxically, the regulatory framework necessary to control the growth of a given aggregate sets in motion forces that ultimately reduce that aggregate's usefulness in policy implementation."[24]

A popular new theory in Washington implies that the ten-year collapse of bond and mortgage markets is due to the ten-week wiggles in M1 since October 1979. Since the Fed stopped stabilizing interest rates, interest rates have, of course, been less stable. Ignoring what interest rates do to the velocity of M1, monetarists say it is changes in M1 that cause changes in short-term interest rates, rather than the other way around.

It isn't a very persuasive argument, so this is how to "prove" it: First, take a four-week moving average of the volume of bank reserves and calculate the percentage change from the same period *a year before*. Plot this on a scale from 1 to 7 percent. Then put *current* interest rates on three-month T-bills on a scale from 10 to 17 percent. For 1981, believe it or not, these two series do appear to move up and down together (though not in 1980 or 1982).

The Shadow Open Market Committee of March 15, 1982 concludes that "this leaves little doubt that interest rates rise and fall directly with growth in reserves." But if 7-percent annual growth of reserves "causes" 17-percent interest rates and 1 percent growth of reserves "causes" 10-percent interest rates, then bank reserves must have been *falling* very rapidly when interest rates were 4 percent (?) A simpler explanation is that the recession lowered both interest rates and reservable deposits last fall.

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[24] Bryon Higgins & Jon Faust, "Velocity Behavior of the New Monetary Aggregates," Federal Reserve Bank of Kansas *Economic Review* (September-October 1981). Also John Wenninger, et. al., "Recent Instability in the Demand for Money," Federal Reserve Bank of New York *Quarterly Review* (Summer 1981).

Output or Prices?

In his classic 1956 restatement, Milton Friedman wrote that "the quantity theory is in the first instance a theory of the demand for money. It is not a theory of output, or of money income, or of the price level."[25] But the elaborate efforts to predict the demand for money broke down with collapse of gold convertibility and pegged exchange rates in 1972–73.

The late Harry Johnson of the University of Chicago decided that monetarism was a passing fad, partly because of the monetarists' habit of "disclaiming the need for an analysis of whether monetary changes affected prices or quantities."[26] Allan Meltzer, for example, acknowledges that "none of our models predict changes in output reliably." Few even try. Two leading Keynesians likewise admit that their models too "were demand-oriented, and paid almost no attention to the supply side of the economy."[27] Hence the supply-side counterrevolution.

But even if the growth of money plus velocity were under control, that is not enough. It is not a matter of indifference whether an 8-percent growth of nominal GNP consists of 8-percent inflation and zero growth or zero inflation and 8-percent real growth. "An increase in real activity raises the demand for real money, which, given nominal money and the rate of interest, is accommodated via a decline in the price level."[28] Real growth is anti-inflationary in fundamental and lasting ways. Yet growth may be stifled by a monetarist regime that cannot distinguish between a demand for cash to finance more real growth (or to guard against insolvency) and some sort of inflationary impulse.

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[25] Milton Friedman (ed.), *Studies in the Quantity Theory of Money*, (University of Chicago 1956) p. 4.

[26] Harry G. Johnson, *On Economics and Society* (University of Chicago 1975).

[27] A. H. Meltzer, "The Great Depression" *Journal of Monetary Economics* (November 1976); Alan Blinder & Robert Solow, "Does Fiscal Policy Still Matter" *Ibid.*

[28] Eugene Fama "Money and Inflation" (unpublished, August 1979).

When not openly applauding stagnation as a "Phillips Curve" cure for inflation, monetarists sometimes make slow money growth an end in itself. "A renewed economic expansion," said a prominent monetarist newsletter last July, "would not be promising for inflation...or effective monetary control."[29] This is what the debate between monetarists and supply-siders is all about. Supply-siders want a monetary policy conducive to increased output at stable prices, not a policy to stamp out each glimmer of economic growth in order to keep M1 down. The supply of money is at best a tool, not a goal, and its value must be judged by results.

Time Lags

Monetarism *has to* postulate a time lag between changes in money and changes in nominal GNP or prices. Otherwise, the results are often perverse. From April through October last year, the monetary base grew at a 2.6 percent annual rate, consumer prices at 10.5 percent. From October to February, the base grew at a 10 percent rate, but consumer prices rose at only a 4.3 percent rate. Without a lag, the uninitiated might suppose that faster growth of the monetary base caused slower inflation, or that the two series are not closely related.

Milton Friedman recently wrote that "the lag between a change in monetary policy and output is roughly six to nine months; between the change in monetary growth and inflation, roughly two years."[30] At the St. Louis Fed, R. W. Hafer says "a 1.0 percentage point increase in the growth of M1B yields an identical increase in the growth of nominal GNP within one year."[31] The President of the St. Louis Fed, however, seems to be defending a *zero* time lag, since his table relates money growth to *simultaneous* changes in GNP.[32] An Atlanta Fed Conference on supply-side economics in April 1982 saw David Meiselman arguing for a lag of 7 quarters, Beryl Sprinkel for a few months. Pick one; something is bound to fit.

[29] Morgan Stanley, "Money and the Economy" July 13, 1981. (Lindley Clark of the *Wall Street Journal* has also written of the virtues of anemic growth).

[30] Quoted in Antonio Martino, *Containing Inflationary Government* (Heritage Foundation 1982) p. 34.

[31] R. W. Hafer, "Much Ado About M2," Federal Reserve Bank of St. Louis *Review* (October 1981). Hafer does not realize that critics of M1 are not necessarily saying M2 is any better.

[32] Lawrence K. Roos, "The Attack on Monetary Targets," *The Wall Street Journal* (February 3, 1982).

If the lag is unknown, there is no way to tell if monetarism is right or wrong. There will always be *some* past period of relatively faster or slower growth of *some* M to "explain," after the fact, why inflation or output went up or down. That sort of retrospective, *ad hoc* monetarism is inherently immune to serious testing.

If the lag *is* known, however, rational expectations would make it disappear. Knowing that more money now would cause more output in six months would make it profitable to build inventories right away, thus eliminating the six-month lag. Knowing that more money would cause inflation in two years would make it profitable to speculate in commodity markets and generally buy before prices went up—thus eliminating the two-year lag.

If the time lag were known, people would act on that information and eliminate the lag. If there is nonetheless an unknown lag; then there is no way of knowing which change in output or price was caused by which change in the volume of cash. Monetarism would then be of little value for predicting the future or even explaining the past. If there is no lag at all, then the causality between money and spending could easily be backwards. That is, decisions to spend more might cause an increase in the supply of money, as people sold assets to get cash.

On the face of it, one might suppose that decisions to spend are based on income, assets, and credit conditions—not merely on how much one happens to keep in a checking account. The idea that total spending can be controlled by controlling the forms of wealth became popular largely because of the apparent discovery of lags between money and GNP.

The notion of money having a known effect on something in the future was thus crucial to plausibility of monetarism, but there is still no justification for it in theory or fact, nor any agreement on how long the lags are.

Do-It-Yourself Monetarism

The supply of money provides *some* information, even aside from velocity and price. Table 1 shows quarterly changes and annual trends in the monetary base, M1, and in nominal and real GNP. Quarterly changes in M1 *appear* to explain *simultaneous* changes in nominal GNP in a few periods, but that causality could obviously be backwards (e.g., observe the generous rise in monetary base and falling M1 during the sharp recession in the second quarter in 1980). And what sense can be made of the first and third quarters of last year, when GNP grew very rapidly as

TABLE 1

Money, Spending and Production
(annual rates of change, rounded)

		Quarterly				Year-to-Year			
		Base	M1	GNP	Real GNP	Base	M1	GNP	Real GNP
1980	I	8	7	13	3	8	8	10	2%
1980	II	6	- 3	- 1	- 10	8	4	8	- 1
1980	III	10	15	12	2	8	6	8	- 1
1980	IV	9	12	15	4	8	7	9	0
1981	I	5	5	19	9	7	7	11	1
1981	II	7	10	5	- 2	8	10	13	3
1981	III	4	0	11	1	6	6	12	3
1981	IV	2	6	5	- 5	4	5	10	1
1982	I	10	11	1	- 4	6	7	5	- 2

Source: Federal Reserve Bank of St. Louis

the base and M1 slowed sharply? The task here is to discover the stability of velocity and the appropriate lag.

The older tradition is that longer-term trends are what matter. On such year-to-year comparisons, M1 growth was unchanged between the third quarters of 1980 and 1981, though the base slowed significantly. With money growth unchanged or tightened, depending on definitions, what happened to the trend of nominal GNP? It *rose* by 50 percent over the year. A few months later, Lawrence Roos wrote that "Both M1B growth and GNP growth have been decreasing steadily since 1979."[33]

Do either the quarterly or annual changes in nominal GNP look "too slow" before the fourth-quarter collapse? If so, then the recession after last July might be blamed on inadequate "aggregate demand," requiring bigger budget deficits or more M1. If not, maybe it is time to discard demand management.

It Won't Work

To summarize, rebuilding long-term financial markets requires a credible long-term policy to maintain reasonable stability in the purchasing power of the dollar. Such a rule *cannot* be expressed as a quantity of money because (1) the definition of money is rapidly

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[33] *Op. cit.*

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changing, (2) velocity is increasingly unpredictable, (3) any lags between changes in money and GNP are implausible or at least unpredictable, (4) spending depends on more than cash balances and desired cash balances depend on more than planned spending, and (5) nobody can tell at the time if a rise in money and spending is financing more real output or rising prices (except by watching prices instead of money stocks).

But that isn't the end of it. If a quantity rule for money could somehow pass these hurdles, it still would not work.

If people thought a quantity rule would work, they would expect inflation to average about zero for decades. The rush to buy long-term bonds would quickly drop interest rates to around 5–6 percent. At such rates, the convenience of checking accounts and currency would make it a waste of time to employ complex cash management schemes. The demand for M1 would surge; velocity would fall.

No fixed growth of M1 or the monetary base could cope with such a sudden rise in the demand for cash. Real cash balances could only rise, as desired, if prices fell abruptly. Sudden deflation would surely prompt an equally sudden violation of the rule. Knowing that, people would not believe the rule in the first place.

If the move to slow growth of M1 was done gradually, to minimize the risk of deflation, that too would not be believed. People would rightly reason that the next president or Fed chairman would probably abandon the predecessor's long-term plan. Thus, long-term interest rates would remain high, and velocity might well speed up by more than M1 was slowing down. With rates high, any temporary reduction of inflation would raise real interest rates, causing bankruptcies that would force abandoning the gradual rule.

Advocates of a quantity rule have had 14 years to agree on one and put it into action. Next time, it will not take that long for interest rates to triple again. Does that have to happen before anyone will admit that this experiment with managed money, like the Continental and Greenback dollars, is also a failure? How bad do things have to get before economists will admit that they made a mistake by endorsing the demolition of proven monetary rules from 1965 to 1973?

Price Rules

If monetary policy cannot effectively stabilize prices indirectly, by controlling quantities of M, then why not focus directly on some sensitive measure of price? If such prices are falling, that would be a sign that the demand for money exceeds the supply—time for the Fed to buy bonds (or gold), or to lower the discount rate or reserve requirements. If prices start to climb, it is time to tighten.

In 1962, this was still the dominant view. Professor Friedman then wrote, in *Capitalism and Freedom*, that "the rule that has most frequently been suggested by people of a genuinely liberal persuasion is a price level rule; namely, a legislative directive to the monetary authorities that they maintain a stable price level."

If monetary policy had followed a price rule in 1928-31, the deflation could have been nipped in the bud. As Lauchlin Currie noted in 1934, "the three years that preceded the depression witnessed a considerable fall in prices not only in this country but throughout the world."[34] Another possible price rule—real interest rates—likewise showed that monetary policy was too tight in 1928-32. Alternatively, the sizable inflow of gold into the U.S. in 1929-30 was an equally clear signal that the supply of dollars was inadequate. The Fed, as Milton Friedman observes, was "contracting the money supply when the gold standard rules called for expansion."[35]

A quantity approach to money, on the other hand, would have given ambiguous signals about deflation until it was too late. There was no significant decline in the money supply until March 1931, and the monetary base continued to rise throughout the 1930-33 deflation, as people held more currency and banks held more reserves. A policy of slowly increasing the monetary base, as some now propose, would not have prevented the Great Contraction. Any price rule or gold standard, however, would have worked.

Broader price indexes, such as the producer price index, are too sluggish, among other problems (they are revised months later; seasonal adjustments and weighing of items are dubious; discounts and quality changes are missed, etc.). Looking at broad price indexes makes it easier to wrongly blame inflation on the "oil shock" of 1974, though commodity prices began rising sharply in

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[34] Lauchlin Currie, "The Failure of Monetary Policy to Prevent the Depression of 1929-32" in *Landmarks in Political Economy* (University of Chicago, 1962).

[35] H. G. Manne & R. L. Miller, *Gold, Money and the Law* (Aldine 1975), p. 75. Also M. Friedman & A. Schwartz, *A Monetary History of the United States* (Princeton 1963) p. 361.

1972. Instead, a price rule must work with instantly available spot commodity prices.

Money and commodity prices often move in roughly similar directions, as Robert Weintraub has noted, so monetary policy at those times could just as well moderate big swings in either one. When the two diverge, however, commodity prices invariably give a more accurate picture of emerging trends in the economy. Growth of M1 was essentially unchanged from 1973 to 1975, at 4.4–5.5 percent, but a price rule would have required a much tighter policy throughout 1972 and 1973, and a much easier policy from April 1974 to July 1975 (when spot commodity prices fell 28 percent).

Table 2 contrasts the monthly information provided by M1 and commodity prices in 1980–81. Either series pointed in the correct direction in 1980, but commodity prices convey a much better picture of the liquidity squeeze from October 1981 into early 1982. The seemingly rapid growth of M1 this period was not sufficient to prevent massive liquidation. An easier policy would have been prudent and desirable, providing people understood that the process would be reversed as soon as commodity prices began to turn up. In other words, chasing the elusive M's from week-to-

TABLE 2

Should the Fed Target Prices or M1?

	1980			1981		
	M1	Commodity Prices	Price Rule	M1	Commodity Prices	Price Rule
Jan.	0.8	2.1	loose	0.8	-2.3%	tight
Feb.	0.8	2.0	loose	0.4	-2.5	tight
Mar.	0	-1.7	tight	1.2	2.0	loose
Apr.	-1.3	-4.7	tight	2.1	1.1	loose
May	-0.2	-7.8	tight	-1.0	-1.4	tight
Jun.	1.2	-3.9	tight	-0.2	-2.1	tight
Jul.	1.1	3.8	loose	0.2	1.3	loose
Aug.	1.8	5.2	loose	0.4	1.0	loose
Sep.	1.4	2.1	loose	0	-2.2	tight
Oct.	1.2	0.8	loose	0.4	-2.0	tight
Nov.	0.5	1.3	loose	0.8	-2.4	tight
Dec.	-0.7	-2.1	tight	1.0	-2.3	tight

Source: U.S. Department of Commerce, *Business Conditions Digest*. Series 85 and 23.

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week prevented the only sensible response to an unnecessarily wrenching deflationary experience.

Other sorts of price targets have been proposed, but most are less direct ways of achieving similar results. Ronald McKinnon of Stanford proposes pegging exchange rates with countries that have a somewhat better track record on inflation, such as Germany and Japan. Edward Yardeni of E. F. Hutton and Donald Hester of the University of Wisconsin suggest keeping real interest rates from drifting too high or too low. Stabilizing commodity prices would do all this and more.

If real interest rates are "too high," there is liquidation of commodities, inventories and assets in order to acquire cash. Commodity prices fall. The dollar's exchange rate will likewise be artificially high, due to short-term capital inflows. Stabilizing the price of gold also stabilizes real interest rates, commodity prices, bond yields and exchange rates. Stabilizing any one of those things, if it could be done, would also tend to stabilize the others.

Since broader price indexes are too insensitive, what about narrowing the list to only one commodity—namely, gold—that is notoriously sensitive to every whiff of inflation or deflation (including the inflationary propsect of war)?

The London gold price dipped in February 1980 and fell 17 percent in March, correctly signalling the March-June decline in commodity prices. Gold rose 17 percent in June 1980, announcing the start of the July-November reflation. Gold prices have fallen since just before the presidential election, stabilizing only during the spurt in both money growth and commodity prices in March-April 1981. Watching gold prices works well, and limiting the extremes would work even better. That is no more difficult than stabilizing wild gyrations in interest or exchange rates, which has often been successfully accomplished.

Participants in the gold market are not only concerned about current inflation, but about future inflation. Price movements thus tend to be exaggerated, when *not* on a gold standard, reflecting changing expectations about future inflation. This may be a useful characteristic, because it is the expectation of future inflation that destroyed the bond market.

In October 1979, when the Federal Reserve announced that it would henceforth pay more attention to quantities of money and less to results, the gold price went from $355 to $675 in only four months. Other factors may have been involved, but it looks like a vote of no confidence. Conversely, the gold price fell sharply ever since the election of President Reagan. No forecaster or monetary aggregate did as good a job as the gold market of predicting how abrupt the disinflation would really be. Money growth was not clearly slow until May–September of last year, and even then the M's were throwing-off conflicting signals.

Convertibility

Paying more attention to the consequences of monetary policy—prices, interest rates and exchange rates—would be a major improvement, but still remains a matter of discretionary management.

In order to institutionalize a price rule, it is necessary to convert dollars for gold, and vice-versa, on demand at a fixed price. The "right price" is that price at which we observe neither inflation nor deflation. The only way that foreigners or speculators could upset the fixed gold-dollar ratio would be by monopolizing the stock of gold or dollars, which is clearly impossible.

Stabilizing the value of dollars in terms of gold is not "price fixing" any more than stabilizing an index of prices would be called "price fixing." "Just as every commodity has a value in terms of the unit," wrote Ralph Hawtrey, "so the unit has a value in terms of each commodity."[36]

There has been a lot of misinformation spread around about the U.S. gold standard in the classical period (1879–1914) or the Bretton Woods era (1945–1973). When the period of managed and floating money since 1968 or 1973 is fairly compared with any sort of gold standard, gold systems show far more real growth, better stability of prices in the short and long run, longer expansions, more world trade, and long-term interest rates never above 5–6 percent.[37] In any case, we can improve upon historical performance by learning from the mistakes.

In 1978, Jurg Niehans of Johns Hopkins observed that "commodity money is the only type of money that...can be said to have passed the test of history," and wondered if "the present period will turn out to be just another interlude." "The analysis of commodity money," Niehans regretted, "has made hardly any progress in the last fifty years. Actually, more knowledge was forgotten than was newly acquired."[38]

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[36] Ralph Hawtrey, *Currency and Credit* (Longmans Green 1919) Ch. 1.

[37] My Gold Commission testimony is condensed in *Economic Impact* 1982/2 (U.S. Govt. Printing Office), and the Federal Reserve Bank of Atlanta will soon release my talk in the proceedings of an April conference on supply-side economics.

In the past few years, however, there has been a gradual rediscovery of the value of commodity money in the work of such scholars as Robert Barro, Fischer Black, Benjamin Klein, Robert Mundell, Robert Hall, Thomas Sargent, Robert Genetski, Richard Zecher, Paul McGouldrick, Michael Bordo and others. This is just the beginning.

David Ricardo wrote about the central bank in England during 1816, a period of fiat money very much like the present. "In the present state of the law," wrote Ricardo, "they have the power, without any control whatever, of increasing or reducing the circulation in any degree they may think proper; a power which should neither be entrusted to the state itself, nor to anybody in it, as there can be no security for the uniformity in the value of the currency when its augmentation or diminution depends solely on the will of the issuers."

"The issue of paper money," said Ricardo, "ought to be under some check and control; and none seems so proper for that purpose as that of subjecting the issuers of paper money to the obligation of paying their notes either in gold coin or bullion."[39]

The Bullion Committee explained the task before Britain reinstated the gold standard in 1821: "The most detailed knowledge of the actual trade of the country, combined with the profound science in all principles of money and circulation, would not allow any man or set of men to adjust, and keep adjusted, the right proportions of circulating medium in a country to the wants of trade."

Britain took Ricardo's advice and enjoyed over a century of unprecedented monetary stability and economic achievement. Eventually, the United States will do the same. There is no viable alternative.

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[38] Jurg Niehans, *The Theory of Money* (Johns Hopkins 1978) pp. 140-41.

[39] David Ricardo, *The Principles of Political Economy and Taxation*.

STATEMENT
on behalf of
NATIONAL ASSOCIATION OF REALTORS ®
regarding
MONETARY POLICY
to the
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
by
DR. JACK CARLSON
August 12, 1982

I am Jack Carlson, Executive Vice President and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS ®.

On behalf of the nearly 600,000 members of the National Association, we greatly appreciate the opportunity to submit our views on the Monetary Policy.

RECOMMENDATIONS

(1) We recommend this Committee consider instructing the Federal Reserve to use short-term interest targets in addition to and consistent with money growth targets, particularly during periods of time when the appropriate long and short-term monetary growth targets of the Federal Reserve are being met.

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(2) We recommend to this committee that it consider recommending to the Federal Reserve that in view of the fact that reductions in money velocity have caused the monetary targets to be increasingly restrictive, the Federal Reserve should consider modifying the money growth targets upward during these periods of reduced money velocity. It is our recommendation that the targets can and should be increased by one percentage point for the remainder of this year and for 1983.

(3) We recommend to this committee that it encourage the Federal Reserve to set a suitable date for implementation of contemporaneous reserve accounting.

(4) We recommend to this committee that it recommend to the Federal Reserve that reducing information by which expectations on the short run money growth policy of the Open Market Committee are formed in the financial markets through averaging the weekly money stock measures is an inappropriate response to the problem of the formation of erroneous expectations. The plan to implement the averaging of the money stock measures should be cancelled. The Federal Reserve should implement measures to increasre the information by which these expectations are formed and not reduce it.

(5) We recommend to this committee that it request the Federal Reserve to consider holding monthly briefings in New York

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and Washington for financial market economists, practitioners, and others whose opinions weigh heavily in the formation of investor expectations and report to the committee as to the feasibility of this proposal. The purpose of the briefing would be to reduce erroneous policy expectations in the financial markets particularly as they relate to factors that influence short and medium term policy modifications by the Open Market Committee.

SUMMARY

(1) Since late in 1979, major elements of Federal Economic Policy have been in direct conflict in that the Federal Reserve has pursued on anti-inflationary policy of credit restraint while the Congress and the Administration have pursued an inflationary policy of fiscal stimulation to increase economic growth and employment.

(2) The result of this policy mix is an unusual set of economic conditions, i.e., lower inflation, higher unemployment, and stagnant economic growth co-existing with high and volatile interest rates.

(3) High and volatile interest rates, by keeping the housing and auto industries, business investment and trade in goods and services depressed is preventing economic recovery and has inflationary implications for the future.

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(4) We agree with Federal Reserve Chairman Volcker that there has to be far more done on the fiscal side in reducing deficits before a sustained and robust economic recovery can ensue.

(5) Interest rate volatility is known to be a major factor in depressing credit dependent industries. This rate volatility has primarily been the result of an erratic growth path for money supply as represented by M1. The Federal Reserve's capacity to control the supply of credit in order to produce a steadily growing money supply is limited.

(6) The Federal Reserve should adopt, as has been recommended by its own staff, a contemporaneous reserve requirement system in order that they have greater short run accuracy in managing reserves to meet money growth objectives.

(7) The current economic conditions have confused the expectations of investors and consumers and they have responded to this by holding large amounts of liquid assets. This has caused changes in money velocity that have necessitated policy modifications by the Federal Reserve with respect to the monetary growth targets.

(8) These policy modifications have not been effectively communicated to the financial markets and have resulted in erroneous monetary policy anticipations by the markets. Interest rates have, therefore, been higher during the early part of 1982 than they would have been if policy expectations had been more accurate.

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(9) The Federal Reserve should implement measures to reduce erroneous policy expectations in the financial markets, particularly as it relates to factors that influence short- and medium-term policy modifications with respect to monetary growth targets.

(10) The economy is now poised for recovery and with inflation currently reduced the Federal Reserve should shift its priority from reducing inflation to encouraging economic growth. It now can safely allow money to grow at least one percentage point above the current target range. This is particularly the case with current high liquidity preferences and low money velocity. The result of this would be to further lower interest rates and relieve some of the pressure from the interest sensitive industries and thrift institutions. A more rapid economic recovery would result from this policy change.

Since late in 1979, the Federal Reserve has pursued a policy of bank reserve management for the purpose of regulating the growth rates of several monetary aggregates within prespecified annual target ranges. The policy was adopted as an approach toward reducing inflation by limiting the growth of nominal GNP. The theoretical justification is that, although there will be short-run impact on real output and employment from restraining money growth, the intermediate and long-term adjustment would primarily come out of the inflation component of nominal GNP which is the desired result. At the time, reducing

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inflation, which was growing during some months at annualized rates in excess of eighteen percent, had acquired a national constituency for making it the primary domestic policy priority.

Although the path of growth in the money aggregates has been volatile, their yearly growth has steadily declined over 1980, 1981, and the first half of 1982; and as consistent with theory, inflation has significantly declined. However, theory also suggests that interest rates should have declined with the reduction of inflation and the slowing of real output growth. This has not occurred. Interest rates and, particularly real interest rates, have reached and maintained record highs.

Figure 1

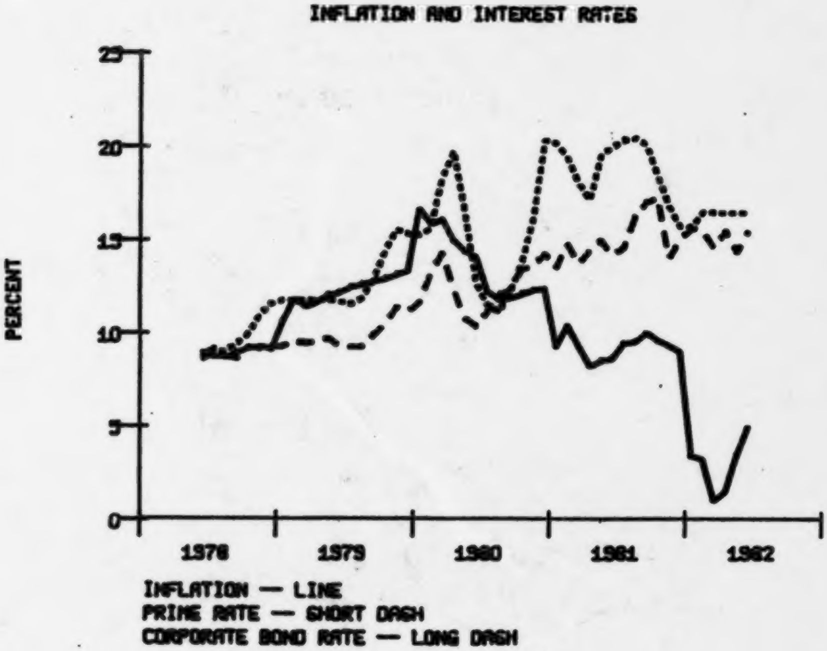

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Figure 2

PERCENT CHANGE IN REAL GNP

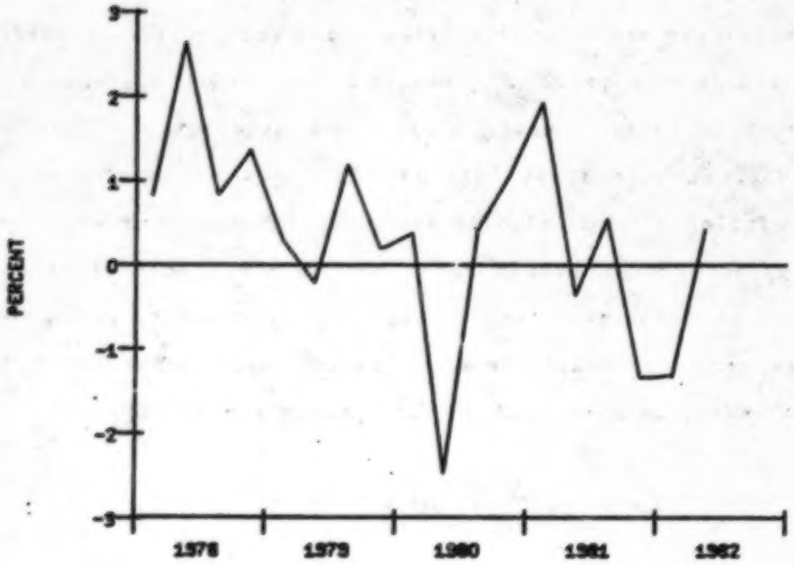

Figure 3

UNEMPLOYMENT RATE

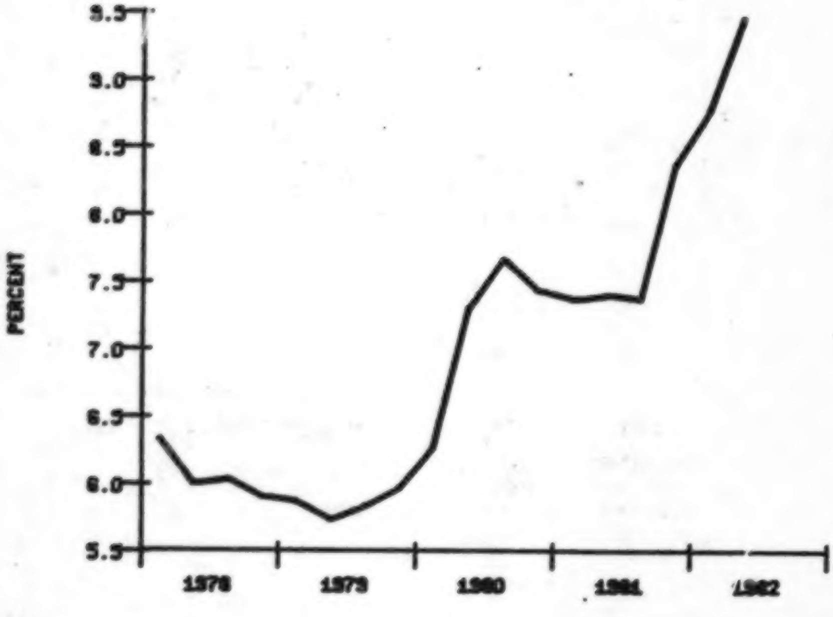

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Figure 4

M1 GROWTH COMPARED TO TARGETS

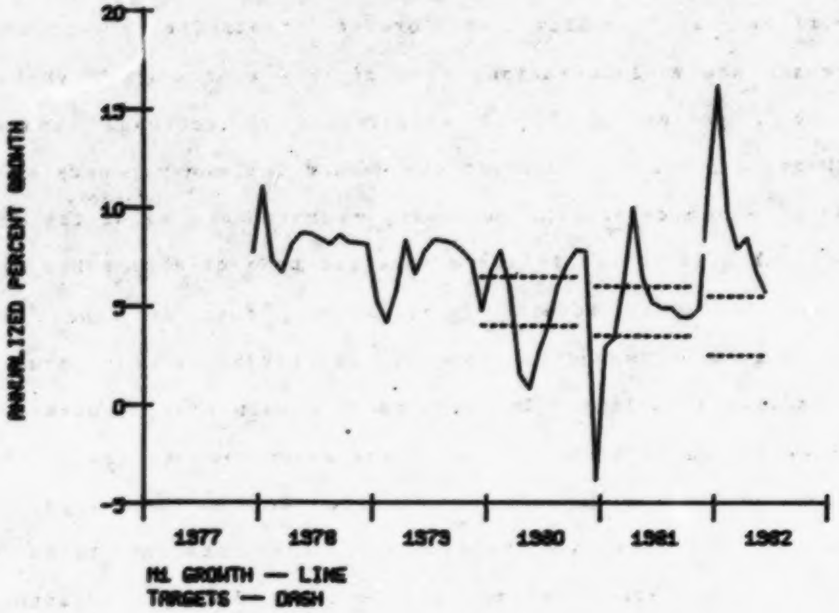
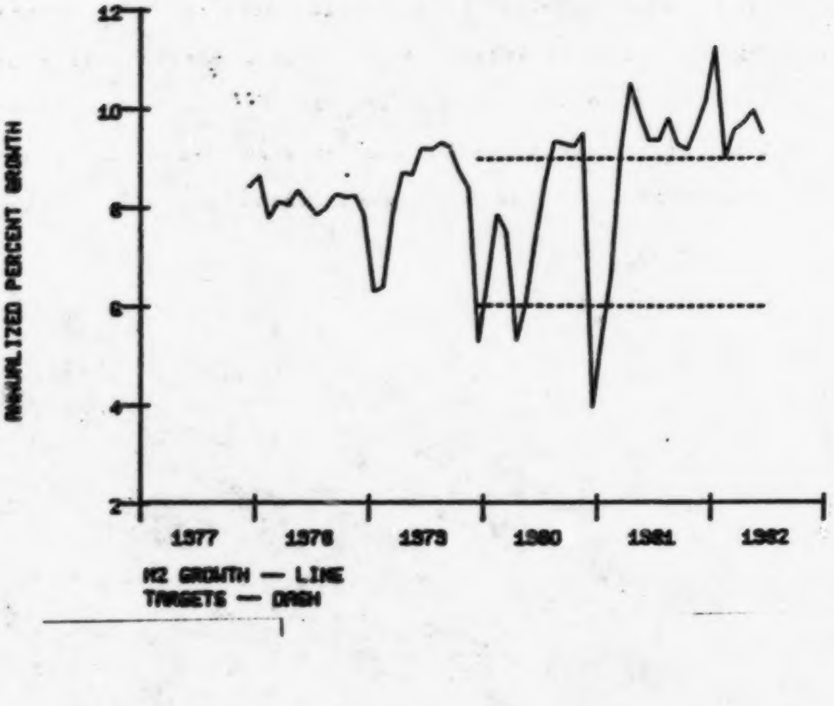


Figure 5

M2 GROWTH COMPARED TO TARGETS



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The primary reason for this departure from theoritical expectations is that while the Federal Reserve was pursuing an anti-inflationary policy of credit restraint, successive Congresses and Administrations have direcly contradicted this by pursuing a policy of fiscal stimulation to increase economic growth and employment. Because the demand for money generated by the large and accelerating borrowing requirements resulting from this fiscal stimulation is large relative to available money, and does not depend on levels of output and cost of funds, the private demand for money had to carry the burden of adjustment to this conflict in policy. Interest rates remain high, contrary to the expectations of theory, because the assumption in theory that the demand for money depends on the price of money and levels of economic output has not held. The high interest rates we currently suffer are in place to effect the downward adjustment in private demands for money in order that the large and growing public demand for money can be accommodated despite the policy of deceleration in money growth being implemented by the Federal Reserve. This conflict in Federal fiscal and monetary policy has currently left us with an unusual set of economic conditions: low inflation, high unemployment, and stagnant economic growth coexisting with high and volatile interest rates.

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Figure 6

THE FEDERAL DEFICIT

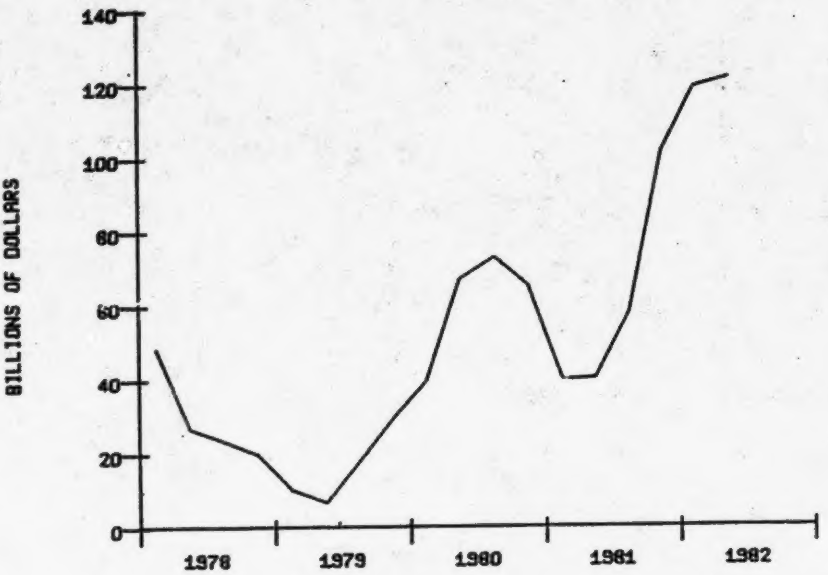

Figure 7

FEDERAL DEFICIT AS A PERCENT OF PERSONAL SAVINGS

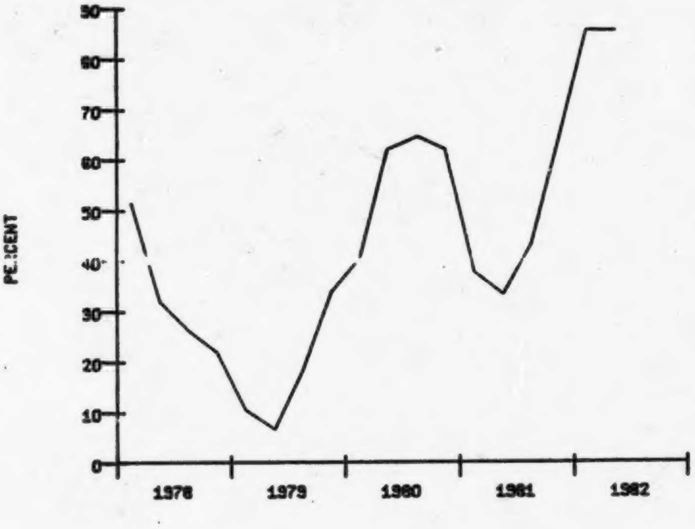

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Figure 8

FEDERAL DEFICIT AS A PERCENT OF PERSONAL SAVINGS PLUS CORPORATE SAVINGS

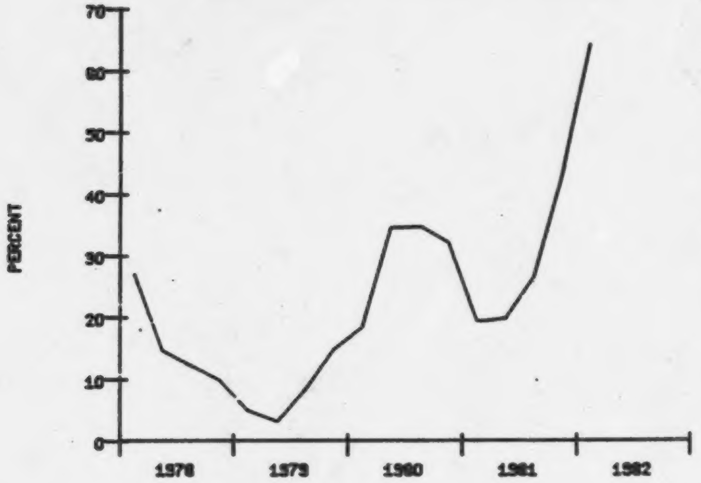

Figure 9

FEDERAL DEFICIT AS A PERCENT OF TOTAL PRIVATE SAVINGS

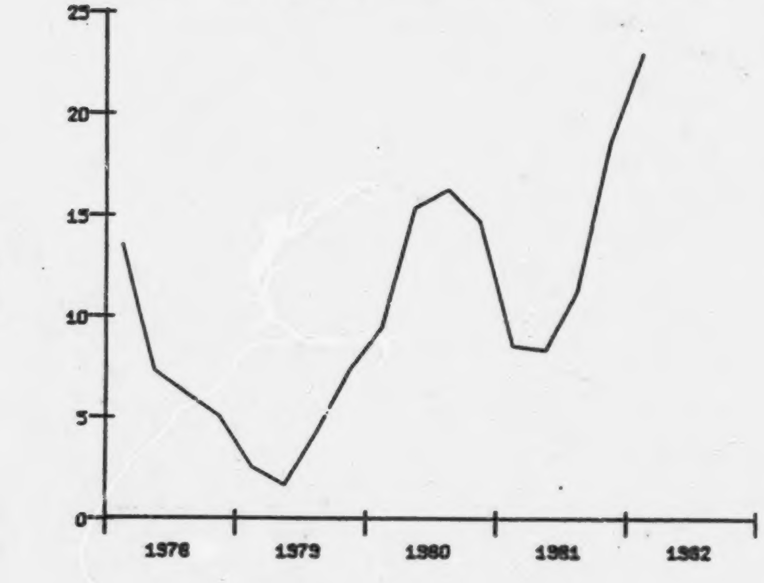

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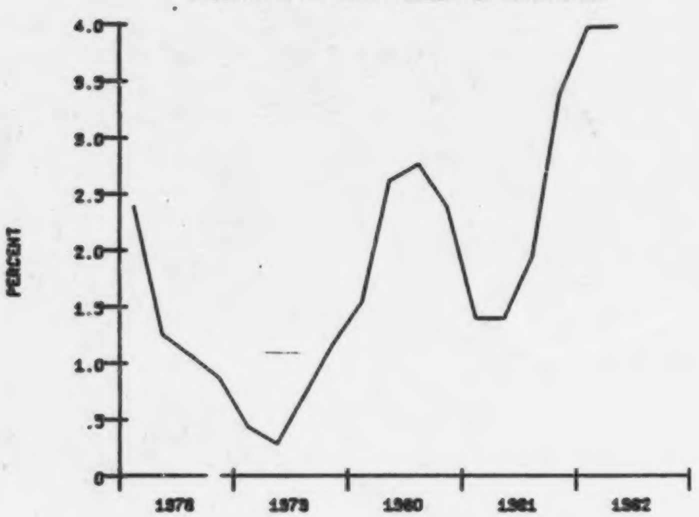
Figure 10



The adjustments forced on private borrowers have, in some cases, been unprecedented since the Great Depression, and no industry has suffered more than the housing industry. For forty months now, housing activity has declined, and this decline has accelerated during the last twelve months. More Americans during the last forty months have lost the opportunity to satisfy their home owner needs than at any other time in United States history. This includes the drop through the years 1929 to 1933. Home sales have fallen 55 percent (from peak to trough) in dramatic and stark contrast to the physical volume of other sales in the national economy which have dropped only about three

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percent. About 3.5 million households have been denied the opportunity to qualify for adequate housing of their own.

Figure 11

HOUSING STARTS AND HOME SALES

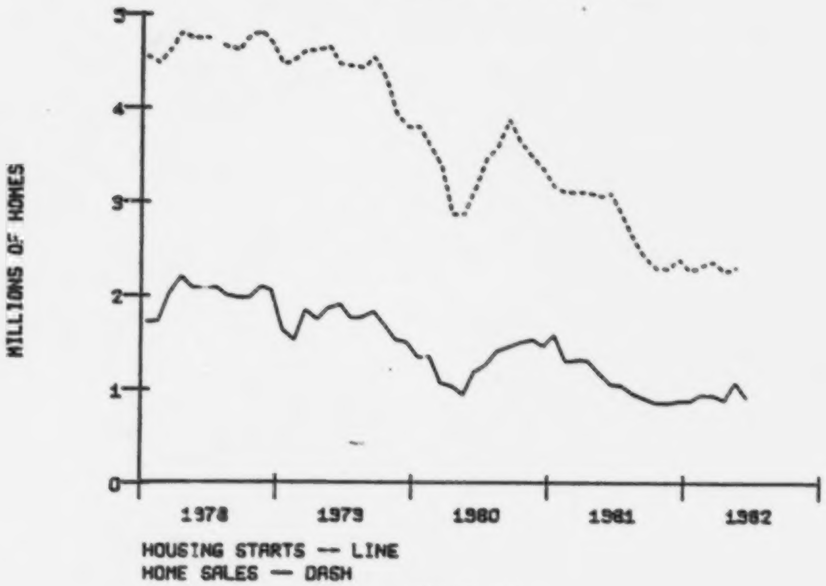
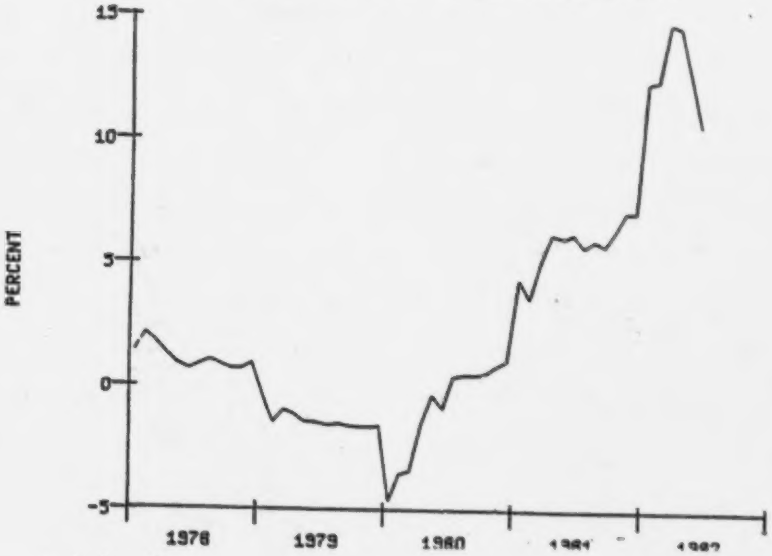


Figure 12

REAL EFFECTIVE CONVENTIONAL MORTGAGE RATE



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This loss has occurred while the demographic demand for housing is not significantly decreasing, even before considering replacement demand. The loss has not only kept would-be home buyers from achieving their dream of home ownership, but has caused home owners to lose as much as one-half of their investment in their homes. This loss occurred because real interest rates for new mortgages (interest rates after adjusting for inflation) have increased from the normal three percent level during the post-war period to highs of of 6.9 percent during 1981, near 15 percent in 1982, and 8.2 percent forecast for 1983.

The higher real interest rates, rising from three percent to above 14 percent, have caused a loss of at least 25 percent of the current marketable value of every American's home, as well as any other long-lived investment such as commercial, industrial, and agricultural real property. When one considers the average equity of people's homes is sixty percent, this means nearly one-half of all Americans' equity in their homes has been taken away because of high real interest rates resulting from this policy conflict.

Along with housing, other credit sensitive industries have been caught in the jaws of this policy conflict. The auto industry and other consumer durable goods industries are heavily affected. Industries that support housing and consumer durable goods such as lumber, steel, plastics, rubber, and others have suffered severe declines. With the general decline in output, and also because of the high cost of funds, investment in plant

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and equipment has fallen drastically. Prolonged depression in investment in housing and business structures and equipment will virtually guarantee high prices and lagging productivity in the future.

Figure 13

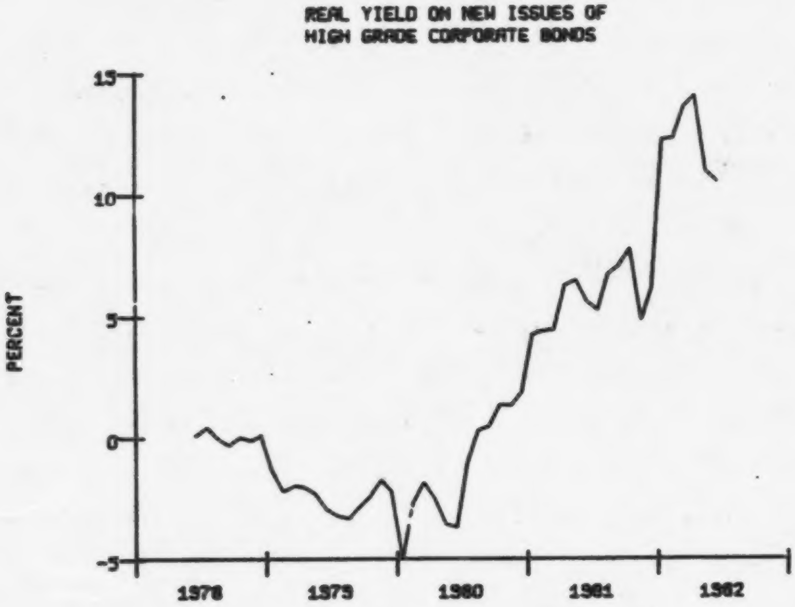

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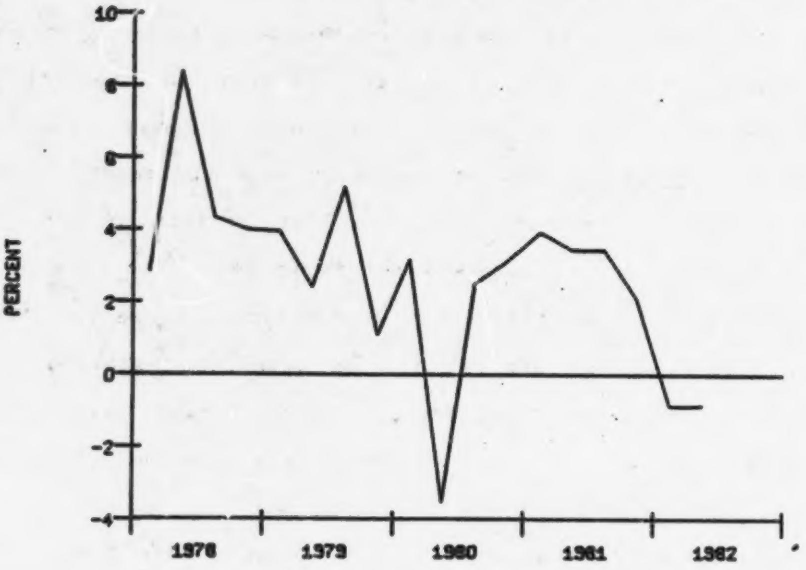
Figure 14

PERCENT CHANGE IN NONRESIDENTIAL INVESTMENT



It has always been known by all of us that the fight against inflation would not be an easy one. There was to be suffering by many in order to achieve price stability. But the method of solely relying on monetary policy as the tool to obtain price stability has resulted in the casualties being predominantly distributed in the credit sensitive industries. Nevertheless, substantial progress has been made in reducing the cost of production and there is now opportunity for strong sustained economic growth with more suitable prices.

Along with the fall in prices, real incomes have been steadily growing. Consumers have been liquidating their debt and

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the debt service to income ratio is the lowest it has been in years. Although there has been some increase in the consumer price index lately, the increases have been centered on energy and housing costs and there are reasons to believe this accelleration will be short-lived, or are the results of statistical quirks. Energy surpluses are beginning to build again as energy producers renig on OPEC production agreements. This may limit future increases in oil prices. The rise in home prices lacks credibility given the current depressed housing market leading to an upward bias in measured inflation. On a more optimistic side, producer prices for finished and intermediate goods, as well as crude materials, continue to be moderate and give reason for optimism that the growth in prices in the future will be moderate. Wage demands have finally begun to moderate with actual wage declines being registered in some cases and capacity utilization is extremely low. These indicate that renewed growth will not be inflationary. The dollar's position on the international currency markets is currently too strong, but should trend toward an appropriate lower value in relation to other currencies as our interst rates decline. Nevertheless, its continued strength will also help keep renewed economic growth noninflationary. Finally, our current confused economic state has driven investors to cautious liquid positions so they are now poised and capable of investing in the new opportunities that would arise in a recovery.

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Figure 15

PERCENT CHANGE IN PRODUCER PRICES
AND AVERAGE HOURLY EARNINGS

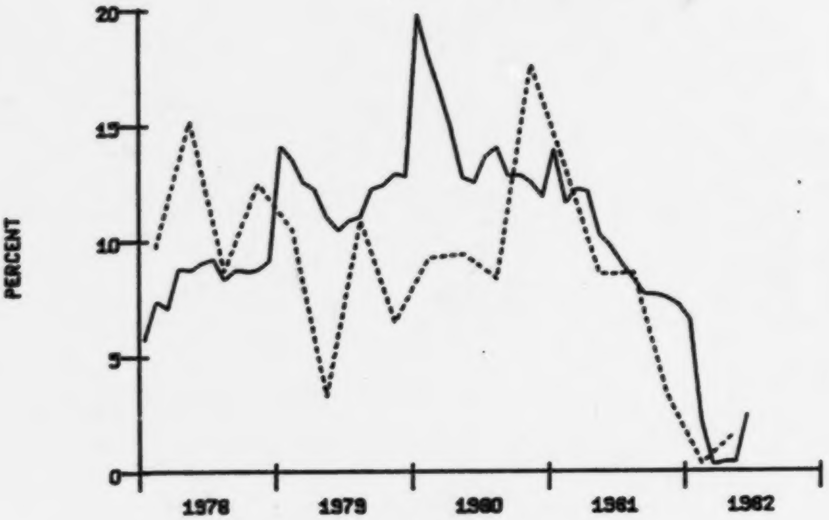

Figure 16

PRODUCER PRICES — LINE
AVERAGE HOURLY EARNINGS — DASH

CAPACITY UTILIZATION

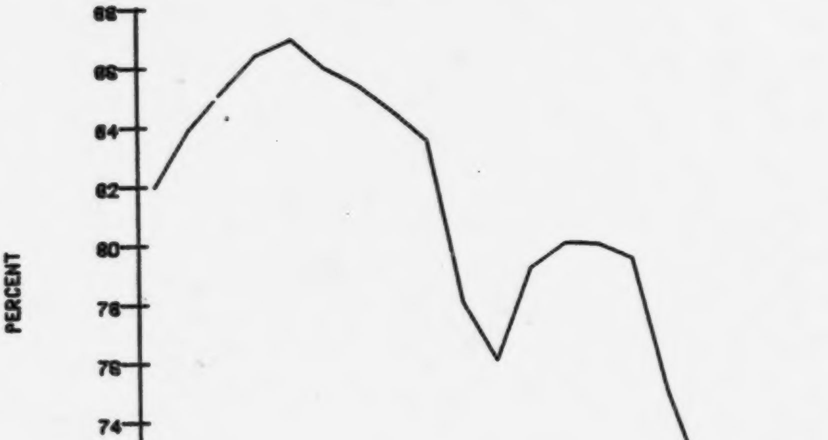

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Figure 17

U.S. TRADE-WEIGHTED EXCHANGE RATE

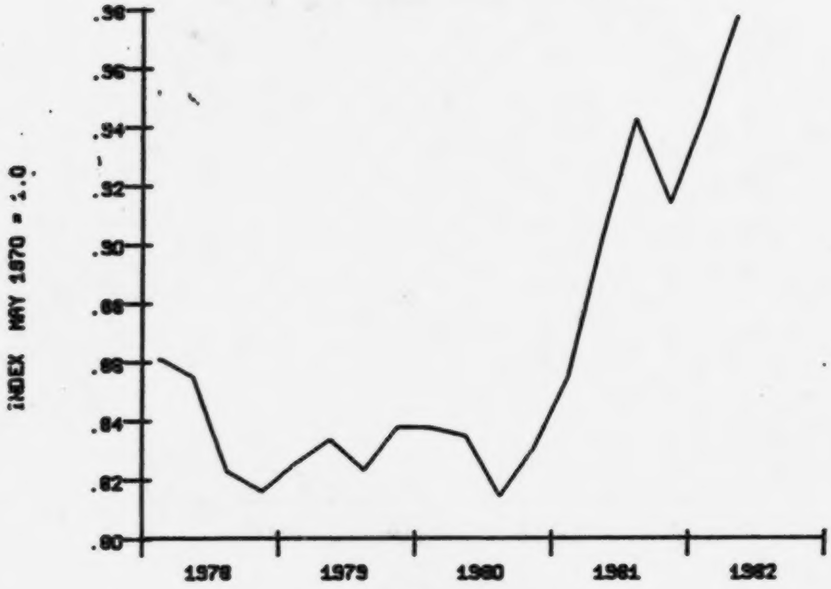
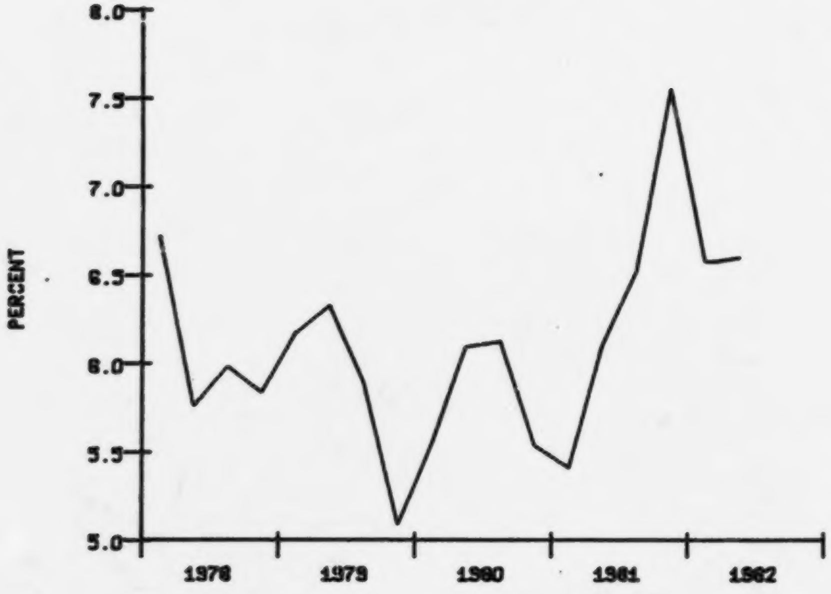


Figure 18

PERSONAL SAVINGS RATE



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However, there will be no strong and sustained recovery until the conflict between fiscal and monetary policy is removed. The economy is now at a crossroad. One road leads to economic recovery and prosperity. The other to depression as the many businesses that have survived so far begin to fail when interest rates do not come down and a recovery does not occur. The way to get on the right road is not now in dispute. Just as the national consensus two years ago was that controlling inflation was the nation's top economic priority, the consensus is now for reducing the federal deficit and borrowing, lowering interest rates, increasing employment and raising the standard of living of Americans. Although the recent budget resolution has been a step in the right direction, we agree with Federal Reserve Chairman Volcker in saying that there has to be far more done on the fiscal side in reducing deficits before a sustained and robust economic recovery can ensue. This is particularly the case if the Congressional Budget Office is correct in saying that even with the expenditure cuts and tax increases in the latest budget resolution, federal deficits will be near $140 to $155 billion over the next three years. This state of affairs simply cannot be allowed to continue.

Reduction of the federal deficit is crucial if economic disaster is to be avoided. In order to bring about this reduction, I sincerely request you give consideration to the recommendations of the NATIONAL ASSOCIATION OF REALTORS ® which are:

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(1) Federal spending growth must be slowed down and reduced in all parts of the federal budget, including defense, entitlement programs, and other programs. Spending this year has overrun the commitments of the President and the Congress by double the rate compared to the last ten years. REALTORS ® have been responsible for recommending many of the cuts which were subsequently proposed by the President and enacted by the Congress last year that affected real estate and we called upon other industries to follow our example of accepting the necessary sacrifices.

(2) Deferral of tax relief planned for July 1983 and indexing scheduled for 1984 should be considered among ways to meet this need.

(3) Tax increases to discourage consumption, but not savings and investment, should be adopted along with spending reductions to help limit the deficit. REALTORS ® in the first place recommended individual tax relief should be limited to five percent across the board each year, instead of ten percent, and that the tax relief should be no larger than spending reductions to achieve a balanced budget by 1984.

(4) Finally, we recommended that Congress adopt a Constitutional Amendment to restrain the growth of federal pending and taxes in relationshiop to the growth of people's income and to restrain the growth of deficits.

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Although reduction in the federal deficit has priority over the range of policy options, improvement in the exercise of monetary policy is also of high importance. Interest rates have been extremely volatile since the Federal Reserve began targeting money growth as its primary policy objective. Also, partly as a result of this concentration on money growth targets, real interest rates have reached prohibitive levels even though inflation has sharply declined. Monetary policy improvements must address these problems of interest rate volatility, the formation of erroneous policy expectations with respect to money growth, and prohibitively high real interest rates. These will be the issues to which our recommendations on monetary policy improvements will be addressed.

With respect to the volatility of interest rates, we know that increased rate volatility is an inherent consequence of the policy technique of targeting money growth. However, the excessive magnitude of the volatility we have experienced has resulted primarily from an unnecessarily erratic growth path in the money supply. Excessive interest rate volatility is a major factor in depressing credit dependent industries. The Federal Reserve's capacity to control the supply of credit in order to produce a steadily growing money supply and stable interst rates has been demonstrated to be limited.

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Techniques of controlling the monetary aggregates have been discussed and the current policy of lagged reserve requirements has received considerable attention. Under lagged reserve requirements, required reserves are to be met with a two-week lag. That is, for average end-of-day deposits during a given seven-day computation week, reserves are to be held during a seven-day maintenance week ending fourteen days after the end of the computation week. Vault cash also is lagged two weeks. That is, vault cash held during the computation week is to be used to satisfy reserve requirements during the maintenance week two weeks later. Also, member banks could not only make up reserve deficiencies in the next reserve maintenance week, but could carry forward excesses into the next maintenance week. This last provision, which is called the carry-over provision, obviously complicated reserve accounting.

Studies by the staff of the Federal Reserve found, as reported in a staff paper to the Board of Governors on September 14, 1981, that there was widespread support for lagged reserve requirements (LRR) among depository institutions because it reduced the costs to banks of acquiring current data on their required reserved in time to adjust their reserve positions. However, LRR added to the size of these adjustments for banks clearing through the Federal Reserve. Movements in reserves over the maintenance week are typically accompanied by movements in deposits in the same direction, and with contemporaneous reserve requirements (CRR), changes in excess reserves are partially offset by the associated changes in required reserves. In contrast, with LRR this offset does not occur and necessitates larger reserve adjustments at the end of each maintenance week.

The study continues by saying that reflecting these additional adjustments, which are made in part via the federal funds transactions and member bank borrowing, LRR added somewhat to pressures for fluctuations in the federal funds rate near the end of the maintenance period. Accordingly, the volume of system defensive open market operations needed to constrain settlement day fluctuation in the funds rate increased.

Finally, the staff report says LRR has no discernable impact on the precision of monetary control under a federal funds rate operating target, which relied mainly on influencing money demanded. However, under a reserve operating target, LRR impairs short-run monetary control by delaying the response of money market interest rates to changes in the quantity of money demanded. For example, with fixed weekly targets for reserves, the switch to CRR would speed up the impact of changes in money or required reserves and interest rates by two weeks. Empirical evidence comparing the relation beteen reserves and money in the years before and after the switch to LRR suggested that month-to-month monetary control could be noticeably improved under reserves targeting by a return to CRR.

Also included in the paper were the recommendations of the staff which state that the return to CRR would entail substantial start-up and continuing costs for both depository institutions and the Federal Reserve System. It would also be considerably more complex administratively, particularly for reserve pass-through relationships, than the present lagged reserve requirement system. Nonetheless, the staff is of the view that a CRR system as proposed in their memorandum is operationally feasible. With regard to the benefits of such a system, CRR would offer the potential for improved month-to-month control over the monetary targets, though the monetary control gains would be appreciably less over longer periods, say a three to six month horizon.

The staff went on to recommend a CRR system with the following features:

(1) Only depository institutions reporting deposits weekly would be subject to CRR.

(2) CRR would apply only to transactions deposits; reserve requirements on other reservable liabilities would continue to be met on a lagged basis.

(3) Vault cash holdings in a previous period would continue to be counted as reserves in the current maintenance period.

(4) The computation period for transactions balances would end on Monday, two days before the end of the maintenance period.

(5) Both the computation and maintenance periods would be two weeks in length rather than the present one week. However, for purposes of the monetary statistics and the estimation of required reserves, deposits would continue to be reported on a weekly basis.

(6) The current carryover limit of plus or minus two percent of daily average required reserves would seem appropriate.

The NATIONAL ASSOCIATION OF REALTORS ® endorses the recommendations of the Federal Reserve staff and requests that this committee encourages the Federal Reserve to set a suitable date for implementation.

The unusual economic conditions and regulatory, attitudinal, and technological evolution, have all made the art of monetary management very difficult. The current economic conditions have confused the expectations of investors and consumers and they have responded to this by holding large amounts of liquid assets. New financial instruments that have been developed having characteristics of both transaction accounts and savings accounts are now widely available to the public, and current conditions are causing them to use these accounts in new ways. Since the monetary aggregates that are targeted for policy purposes are defined on the basis of accounts that segregate the transaction and saving functions, setting policy based on those aggregates is sometimes difficult to sustain and more importantly for short run interest rates, difficult to interpret.

Chairman Volcker has testified, "the great bulk of the increase in M1 during the early part of the year--almost 90 percent of the rise from the fourth quarter of 1981 to the second quarter of 1982--was concentrated in NOW accounts, even though only about a fifth of total M1 is held in that form." He also states, "In contrast to the steep downward trend in low interest savings accounts in recent years, savings account holdings have stabilized or even increased in 1982, suggesting the importance of a high degree of liquidity to many individuals in allocating their funds. A similar tendency to hold more savings deposits has been observed in earlier recessions."

In the Federal Reserve's Midyear Monetary Policy Report to Congress it states, "Looking at the components of M2 not also included in M1, the so-called non-transaction components, these items grew at a 10-3/4 percent annual rate from the fourth quarter of June 1982. General purpose and broker/dealer money market mutual funds were an especially strong component of M2, increasing at almost a 30 percent annual rate this year. Compared with last year, however, when the assets of such money funds more than doubled, this year's increase represents a sharp deceleration." Money market mutual funds are similar to NOW accounts in that they have characteristics of both transactions and savings accounts. The report continues, "after declining in each of the past four years--falling 16 percent last year--savings deposits have increased at about a 4 percent annual rate thus far this year. This turnaround in savings deposits flows, taken together with the strong increase in NOW accounts and the still substantial growth in money funds, suggests that stronger preferences to hold safe and highly liquid financial assets in the current recessionary environment are bolstering the demand for M2 as well as M1."

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This increased demand for M1 and M2 affects the ratio of these aggregates to gross national product. This has policy implications because the determination of whether money growth is excessive or constraining is based on an assumed ratio of the money aggregate to gross national product. An assumed velocity if you will. That is how the target ranges are decided upon.

Chairman Volcker stated, "the Committee (Open Market Committee) was sensitive to indications that the desire of individuals and others for liquidity was urusually high, apparently reflecting concerns and uncertainties about the business and financial situation," he also states, "Judgments on these seemingly technical considerations inevitably take considerable importance in the target-setting process because the economic and financial consequences (including the consequences for interest rates) of a particular M1 or M2 increase are dependent on the demand for money." In other words, the determination of whether money is tight or loose at a particular level depends on the velocity to a considerable extent. In reference to Federal reserve policy early this year when money growth was well above target, Chairman Volcker states "In the light of the evidence of the desire to hold more NOW accounts and other liquid balances for precautionary rather than transaction purposes during the months of recession, strong efforts to reduce further the growth rate of the monetary aggregate appeared inappropriate." He continued, "Moreover--and I would emphasize this--growth somewhat above the target ranges would be tolerated for a time in circumstances in which it appeared that

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precautionary or liquidity motivations, during a period of economic uncertainty and turbulence, were leading to stronger than anticipated demands for money." The Chairman also stated that the behavior of velocity and interest rates weighed heavily in this policy determination.

The problem with this is that just as the Federal Reserve's policy decisions on acceptable money growth is complicated by the velocity problem, it is doubly difficult for the members of the financial community who have recently had to trade based on expectations of Federal Reserve policy, to form expectations on that policy. The importance of Federal Reserve policy is indicated by the attention that is paid to the weekly release of the monetary aggregates. This attention has been so great that the expectations formed by them have been of some concern at the Federal Reserve. Recently, the Federal Reserve has said it intends to counter this by averaging the weekly numbers to reduce their volatility and hopefully their importance in forming expectations about Federal Reserve policy.

It is our feeling that this is the exact opposite of the approach the Federal Reserve should take to this problem. Instead of trying to reduce the information available to the financial markets for forming expectations on Federal Reserve policy, they should be increasing it. During the early part of this year expectations of emminent tightening of money growth and higher interest rates were formed because of persistent money growth above Federal Reserve targets. The expectations of higher interest rates inflated long term interest rates and drove long term borrowers into the short term market which helped inflate those rates as well. The statements of Chairman Volcker on the policy considerations of the Open Market Committee at the time indicate that these expectations were overly pessimistic. When the Open Market Committee modified its policy due to velocity and liquidity preference changes, the modification was not effectively communicated to the financial markets. This resulted in erroneous expectations and probably resulted in interest rates being higher than they would have been if policy expectations had been more accurate.

We believe the Federal Reserve should implement measures to reduce erroneous policy expectations in the financial markets particularly as they result from short and medium term policy modifications by the Open Market Committee. Just as the Federal Reserve periodically reports to Congress on Federal Reserve policy and responds to their questions, they should perform a similar function for members of the financial markets. What we propose is that the Federal Reserve hold monthly public briefings in New York and Washington for financial market officials and the public whose opinions weigh heavily in the formation of investor expectations. These briefings should be held soon after each meeting of the Open Market Committee and should be conducted by the Federal Reserve Chairman, a Federal Reserve Governor, or possibly a member of the Open Market Committee. The subject of the meetings would be the short-run targets for money growth of the Committee. Also discussed would be factors which could cause variance from the Committee's targeted growth path and what the likely Committee response to those variances would be.

It is our feeling that such briefings would reduce much of the uncertainty in the financial markets with respect to Federal Reserve policy for management of money growth. This would certainly reduce the impact of volatile movements in the money stock measures on interest rates and could, therefore, reduce the large risk premiums that are currently imbedded in those rates. We strongly encourage this committee to request that the Federal Reserve consider this proposal and report on its feasibility.

Finally, I would like to address the problem of sustained high real interest rates that are enduring despite our current reduced level of inflation. To be sure, the primary policy measure to be taken to remedy this problem is to reduce excessive borrowing by the Federal Government. However, the Federal Reserve must also have a responsibility to help maintain real interest rates at levels necessary to promote growth in output and employment with low inflation and stable prices. The economy, though currently languishing in a deep recession, is now poised for a recovery. With wage growth moderating, capacity utilization low and consumer liquidty high, we now have our best opportunity to initiate a sound recovery with low rates of inflation. Our priorities must now turn to this recovery which will bring the country back to economic prosperity. Monetary policy must do its part to help bring the recovery about, and to

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continue to play a role in sustaining strong economic growth by keeping real interest rates from reaching excessive levels.

The NATIONAL ASSOCIATION OF REALTORS ® has in the past and continues to support the Federal Reserve's policy of gradual reduction in the rate of growth of money and credit in order to reduce inflation. However, we would like to additionally recommend at this time that this committee consider requiring the Federal Reserve through amendments of the relevant sections of the Federal Reserve Act, to utilize the policy tools at its disposal to maintain real short-term interest rates at historic evels (3 to 4 percent) during any periods of time that the long and short-term monetary monetary growth targets of the Federal Reserve are being met.

The adoption of this proposal would insure that during periods where low inflation and high real interest rates exist while money growth is within the short and long run target ranges of the Federal Reserve, monetary policy would shift in priority from restraining inflation by reducing money growth to encouraging economic growth and higher employment by reducing real interest rates. It is our feeling that current Federal Reserve policy has not been aggressive enough in helping to bring economic recovery even though inflation is low and money is growing at acceptable rates. Our recommendation will ensure that the appropriate monetary policy priorities are being exercised relative to the prevailing economic conditions.

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Consistent with this idea of matching policy priorities with prevailing economic considerations, it is our feeling that the Federal Reserve should review its short run monetary growth targets given the high liquidity preferences of the public and the resulting low money velocity. Considering also the low current rates of inflation, the Federal Reserve can now safely allow money to grow at least one percentage point above the current target range for the remainder of this year and through 1983. The result of this would be to further lower interest rates and relieve some of the pressure from interest sensitive industries and thrift institutions. A more rapid economic recovery would surely result from this policy modification. Unfortunately, however, this policy and other Federal Reserve policies to lower real interest rates can not be expected to be maintained unless runaway Federal deficits are brought under control and reduced.

In conclusion, I would like to say that the Federal Reserve must be commended for its effectiveness in reducing inflation in this country. However, the execution of Federal fiscal and monetary policy must be improved and made consistent if we are to have a strong sustained recovery and balanced economic growth with high employment, low inflation, and an increasing standard of living for all Americans. It is to this end that our recommendations are here presented to this committee.

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